CORPORATIONS

AND THEIR

FINANCING

BY

HASTINGS LYON

ASSOCIATE PROFESSOR OF FINANCE
SCHOOL OF BUSINESS, COLUMBIA UNIVERSITY
MEMBER OF THE NEW YORK BAR

D. C. HEATH AND COMPANY

BOSTON NEW YORK CHICAGO ATLANTA
DALLAS SAN FRANCISCO LONDON

3 D 9

PRINTED IN THE UNITED STATES OF AMERICA

PREFACE

For many years my colleagues in the School of Business, Columbia University, and I have been working on the desirable content of an introductory course in Corporation Finance, and have come to some convictions about it. In my case the cogency of their reasons, my own experience in investment banking houses, in teaching and in practice, have developed these convictions. *Corporations and Their Financing* results from my endeavor to formulate a text for such a course.

Some may object to the book for presenting so much of the law background. But in this subject, as elsewhere, we need to get back of phenomena to noumena, and through the law we often most clearly perceive the formative ideas.

No one can understand corporate issues of securities without understanding the nature and process of functioning of the corporate group. I have tried to give enough of this for a comprehension of the financing operations. Hence the shift in the title from the more conventional "Corporation Finance" to "Corporations and Their Financing." Some schools do not make a course in the organization of business a prerequisite to the special study of corporate enterprise.

Many years ago I came to the conclusion that few young men seeking to understand corporate securities know enough about a mortgage to comprehend the nature of mortgage security for corporation bonds or the problems of corporate reorganization. On my recommendation the Investment Bankers Association published *Individual and Corporation Mortgages*, by William Lilly, Esq., whom I persuaded to write this little work for laymen. It is now out of print. This fact, and the convenience of having the primary text material for a course in a single book, led to the inclusion here of an equivalent presentation of the mortgage.

Recent Federal legislation has so greatly affected the issuance and the primary and secondary marketing of securities that consideration must be given to it in an adequate course. An endeavor to bring this matter within the scope of such a text as this has been difficult and unsatisfactory. The new statutes put us all on un-

familiar ground. They have not yet been interpreted. At least some of this legislation may be unconstitutional. It may disappear with a change in political viewpoint. But it is now being administered and requires recognition.

In dealing with secondary as well as primary markets for securities this book presents a section on the Stock Exchange. For those schools which do not give courses on the subject and for students who do not take such courses as are given, I believe that the chapters in this section will help to an understanding of Stock Exchange techniques.

The approach throughout is the idea of group functioning, which I believe to be at the core of the subject.

Professor Olin G. Saxon of Yale read the manuscript, contributed many helpful ideas, and saved me from various errors. He should not, however, be held in any way responsible for those that remain. The subject is too extensive for a single reading to perceive the accuracy or inaccuracy of all statements in a long text.

HASTINGS LYON

New York City, 1938

CONTENTS

First Section

The Corporate Enterprise

Second Section

Concept of Capital Stock

Third Section

Creditor Securities

Fourth Section

Capitalization: Expansion

Fifth Section

Changes in Membership of Shareholder and Creditor Groups

Sixth Section

Marketing Securities

Seventh Section

Internal Financing and Corporate Income

Eighth Section

Reorganization: Settling the Affairs of the Corporate Enterprise in Financial Difficulties

Ninth Section

Capital for Corporations

Tenth Section

Secondary Market of the Stock Exchange

Eleventh Section

Federal Taxation and Regulation

First Section

The Corporate Enterprise

CHAPTER I

Special Group Mechanism as the Essential Characteristic of Corporate Business Enterprise

Functions of business are the same whether the form of organization be individual enterprise, partnership, or corporation.

If the enterprise be merchandising, goods are bought, transported, kept in stock, and sold. It creates time and place values. A service is rendered in the advertising and physical display of the goods, in the consummation of the sale, extension of credit, and otherwise. The enterprise requires capital to finance the goods from the time of purchase to the time of payment on resales. It requires capital for equipment, for the space in which the business is conducted. Such space, whether owned, or occupied under lease at a fixed charge for rental, is capital used in the business.

The owners of the enterprise assume various risks in their efforts to create values. These are market, credit, and casualty risks. They also incur varied expense in this endeavor, and in rendering the service. Creation of the values is itself a service. If the management's selection of risk is sound, the enterprise is successful and makes a profit or receives compensation for its services greater than they cost. On an unsuccessful selection of hazards the enterprise fails.

A manufacturing enterprise creates all the values of a merchandising venture, and, in addition, creates form values. There are capital requirements, assumptions of risks, rendering of services, as in a merchandising business, with the corresponding consequences of profit or loss.

Transportation ventures create place values, but do not assume the market risks of the merchant or the manufacturer. The risks lie in judging the demand for their services. If the service costs less than the compensation received and the demand is satisfac-

tory, the enterprise succeeds; if it costs more, the enterprise fails.

So one could go on indicating the essential economic function of communication and other public utility enterprises, as gas, electric light and power, water, etc. One could do the same thing for the extractive industries, as agriculture, fishing, and mining, and for the numerous specialized forms of service enterprises. For all the business as such involves the same problems, varying somewhat with the type or each enterprise. Each employs capital and labor. Each in its special way participates in economic risk.

Out of the gross receipts for goods and services sold, labor takes its wage. Those who furnish materials and supplies receive payment. The state exacts its substantial toll of taxes. If by good fortune and the skill of the enterprisers anything remains, something must be set aside for depreciation of plant and equipment before those who furnish the tools for labor receive compensation for the risks to which they have subjected their capital. Temporarily, to be sure, payments can be made out of what should be set aside for depreciation. But such action defeats itself, and results in the loss of the tools which capital has supplied and which labor uses to earn its wage. However, we are not here primarily concerned with the business process, but with the organization of that process.

The usual short analysis of men's economic activity pictures the enterpriser as contributing capital, assuming risks, and contractually acquiring the use of other capital for an agreed compensation of interest or rent. Borrowed capital is either long term, obtained from investor-lenders, or short term, obtained from banks or by means of credits on goods purchased. Those who contractually supply such capital may or may not receive special security from the borrowing enterprise tending to assure repayment.

Whether specially secured or not, these lenders assume risks in the enterprise along with the contributors of capital. If the enterprise is sufficiently unsuccessful, the lenders will lose after the owners have lost all. This may be true even though such suppliers of capital on contract get back the specific capital supplied, as the landlord whose tenant cannot pay the rent, or the lending bondholders whose capital stands in the converted form of specific property mortgaged to them as security. The landlord of the defaulted lease repossesses the premises; the bondholders in foreclosure acquire the mortgaged assets. For the people who furnish

such capital specifically contract with the owner of the enterprise that the owner should assume for the contract period the primary risks of its use. If the venture is unsuccessful they may find themselves with those risks back on their hands, even before the contract period has expired; but meantime they have avoided the primary risks of the enterprise.

All these phenomena of business are the same for individual, partnership, or corporate forms of organization. In the course of economic and social change, with the rapid expansion of transportation and communication facilities and the consequent widening of domestic and foreign markets, with the development of mechanical invention, with the most effective tool representing a large capital investment, with the process of manufacture rapidly and constantly changing until an entire plant becomes essentially a single tool in so-called mass production, the larger and more highly organized units of business have decided advantages over the smaller in many types of enterprise.

Keeping pace with mechanical invention, social invention has developed efficient devices for assembling the capital these larger units require, chiefly through the use of the corporate and auxiliary mechanisms. Individuals and partnerships still carry on farming, fishing, merchandising, some manufacture, the service trades, and the professions. After losing most of the transportation to the corporate form, the older forms re-enter the field more extensively with the development of the automobile. Wherever the most effective tool becomes enormously expensive, requiring large capital resources, the older form of business organization, less effective than the newer corporation in obtaining such resources, has to withdraw or reorganize. Today corporations do most of the manufacturing. They still do the heavy bulk transportation. In the utility field the cost of the effective tool again places successful enterprises beyond the reach of the individual or partnership.

Corporations have entered the merchandising field from causes other than the cost of the effective tool. In the wholesale division of merchandising, the individual and partnership enterprise can still effectively obtain capital; but the limited liability of corporations, and the advantages gained from large quantity discounts, more available to the highly capitalized corporate units, have been pressing them to incorporate. Yet individual enterprise still does most of the retail selling. For here, though on a decreasing scale (in view of chain stores and mail order houses), volume transac-

tions are not so important, and retail markets are less volatile, which fact reduces the market risks. Whether the corporate invasions of this territory will extend further, or will withdraw in part, remains to be seen. For many social and political forces are aligned against this invasion. It is the old story — in human affairs nothing is constant except change.

Meanwhile we have the corporation with us as the instrumentality through which we carry on our endeavors in a large area of our economic life.[1]

Private business corporations came into use, and the use has steadily increased, through the need of massing capital for undertakings that can be more advantageously carried out on a large scale. The amount of capital required often runs beyond the means of the average individual, and even beyond those of such a small group as can succeed in transacting business as a partnership. Development of the corporate form has largely been the development of ideas to enable a larger group to act effectively and promptly as a unit. In the course of corporate functioning one finds, not just one group, but several groups, and not just one group device, but several.

STOCKHOLDER GROUP

In human affairs Minerva (in the aspect of invention) seldom springs full panoplied from the head of Zeus. Men are not Joves. With mortals change takes place mostly through a process of trial and error. Early railroad cars resemble stagecoaches. Skyscrapers at the beginning bear cornices. The first automobile looks like a buggy without shafts. We keep in touch with precedent. Our mortality does not like to witness the death of things it has known and cherished. Human experience has at times found that sudden or complete severance ends in disaster. This is true of social change, in the development of social instrumentalities, as well as in the changes of invention in the physical field.

In our social system, which has developed on the basis of private property, freedom of initiative, and freedom of competition, we have in our economic affairs the concept of an owner conducting

[1] For a presentation of the extent of corporate enterprise see A. A. Berle and Gardiner Means, *The Modern Corporation and Private Property*, Chap. III, "The Concentration of Economic Power." Commerce Clearing House, Inc., New York, 1932.

any lawful enterprise in such way as he chooses through any lawful means. Though a large group may take the place of an individual owner, that concept continues. To provide the amount of owner's capital necessary for the large enterprise unit, the resources of many men must be drawn upon. In so doing, the risks of ownership are spread on a broader base. At the same time, however, the chances of profit are likewise spread. For all contributors, other than lenders, are joint owners and stockholders who share the profits and losses on a pro rata basis.

We shall consider the manner in which the resources are obtained and an ownership group formed. We shall consider the methods of its functioning for the purpose of action in conducting enterprise. For the moment we are disregarding convenient enough legal fictions of corporate personality and the like. In the conduct of human affairs it is human beings who have the wills and purposes; it is human beings who toil; it is human beings who enjoy the results of labor; it is human beings who suffer the losses of economic hazards.

BONDHOLDER GROUP

An owner conducting an enterprise has various ways of supplying it with the capital used in its business. He may exercise his own right of control over wealth to commit it to the economic purposes of the business undertaking. This is his capital contribution. But the wealth of the owner may not be adequate for his purposes. He may not desire to assume the entire risk. He may bargain with others for their rights of control of wealth. The bargain may be that the owner will assume those rights on a promise to restore them at some future day. So the capital commitment stands on the terms of a debtor and creditor contract. Again, the agreement may be that specific wealth will be put to the use of the business on an agreement that the same specific wealth will be restored to the possession of its owner at the agreed day in the future. So the terms of a lease commit capital to the use of the enterprise.

However, we are not concerned at the moment with the lessee-lessor relationship, but with that of debtor and creditor. A corporate group owner may obtain creditor capital as well as an individual owner. As in the case of the contributed capital of stockholders, the requirements of corporate borrowing may be of such magnitude that a single lender cannot satisfy them. Many

single lenders, each making an independent loan, might do so, with no need for creditor group action to arise. But there may be complications which make the organization of a group creditor necessary or desirable.

It is only under circumstances in which a number of individuals must provide the means of establishing a *single* effective will-for-action that we have a group situation. We have such a circumstance whenever the borrower gives a single and indivisible security to a number of lenders. Each has a lender's interest in the joint or common security, just as each stockholder has an owner's interest in the joint enterprise. The fact of a single security creates an "as if" situation — it is as if there were a single lender and a single loan. In asserting rights against the security for the loan the various lenders (or series thereof) must act as if they had a single will. Pledged collateral must be sold or a mortgage must be foreclosed. Even though no security may be involved, nevertheless there may be reasons for providing a number of creditors, all lending on the same terms, with the means for acting together in the assertion of their rights.

Out of these needs developed the ideas appearing in the corporate mortgage and deed of trust, in the collateral trust indenture, or indenture providing for group action even though there is no pledged collateral. All these are devices for bringing possibly divergent wills into the effect of a single will-for-action, and make possible the large bondholder group creditor, just as the corporate form makes possible the large stockholder group owner.

GROUPS TO ASSEMBLE GROUPS

If the capital stock of an enterprise, or an issue of its bonds, is to be $10,000,000, it will take two thousand people supplying $5000 each to make up the amount. Two thousand men would make two regiments. A large theater could not seat them. Each must make up his mind to join the stockholder or creditor group. The sum of $5000 is not insignificant. It is a fairly large commitment for one person. It will buy a very modest house or a very expensive automobile. How are two thousand people, each willing to invest such a sum, to be assembled so that their individual wills may join in the common purpose?

Middlemen have become a part of the organization of society for this as for other economic ends. We have merchants of se-

curities and agents for their sale. Though a merchant on a large scale may perhaps lay in a million dollar stock and hope to find customers, a ten million dollar stock presents a most formidable task. The ten million dollar issue of securities is a ten million dollar stock of one kind of goods in the same sense as ten thousand Buicks in the hands of a dealer would constitute his stock. A quick turnover is of the essence of the merchandising in either case.

So security merchants resort to a group form of enterprise. In their case the groups remain of the non-flexible Common Law partnership type. They organize for the special object of marketing an individual issue, and disband when that object is achieved, sometimes before full achievement. They enter upon a joint venture. Since their joint ventures are the marketing of stocks and bonds, we call them *security syndicates.* In their formation, operation, and dissolution they present so many special aspects of group functioning as to warrant detailed consideration in due course.

PROTECTIVE COMMITTEE GROUPS

Stockholder groups, creditor groups, and security marketing groups set the corporate enterprise on its way, and through them it functions in its continued capital financing. As long as the business continues solvent they are the essential groups. But on insolvency the stockholder group, or, it may be, the several subgroups of classes of stockholders, and the creditor group or groups may have to assemble, again using the word in the sense of bringing about a resolution of the individual wills into a prevailing will-for-action.

It may be that the individual wills are too divergent, and one or more of the several groups of classes of security holders may split into adverse groups, each trying to make a different will effective. Or, one of the adverse groups may agree on a settlement without resorting to its legal rights. In this case, and to this extent, the individual wills in the group are in real agreement. Their union makes an actual group will; not a new and different will, but simply an actual coincidence of individual wills. If adverse groups cannot reach an accord, receivership or bankruptcy ensues through appeal to the courts. The device of the *protective committee* affords the means through which the individual wills come into and show their coincidence or formulate a will-for-action.

Again, we shall have occasion to consider all this in detail when we come to the topic of corporate reorganization.

STUDY OF CORPORATIONS AND THEIR FINANCING IN PART A STUDY OF GROUP DEVICES

So we see that a study of corporations and their financing becomes in considerable part a study of the formation and functioning of relatively large groups in various aspects of business enterprise. To say that the private corporation form developed out of the need of a means for effective large group action in business may seem a mere stating of the obvious. Yet if the student of corporations will keep this essential character in mind, he probably will find it helpful in understanding the device of the corporation and its auxiliary devices.

Though the corporate instrument developed out of the need for large group action, we see it often utilized, for other advantages, when such action is not required, even to the point of an individual acquiring for himself all the group rights and being the sole stockholder. Even so, as we shall see, he possesses the potentiality of a group, though he may not in the least care for the power.

FUNGIBLE PROPERTY

Except for security syndicates, all these groups are capable of changing, expanding and contracting membership. The property interests of the members have the characteristics of fungibility. The old quarter, sixteenth, thirty-second, sixty-fourth merchant joint interest in the profits, losses, or insurance of the voyage of a ship and its cargo have expanded to a possible divisibility of a one millionth part of a joint ownership interest in a modern enterprise, or a one hundred-thousandth part of an interest in a secured loan. And the fact that the enterprise is indivisible, or the security indivisible, makes the fractional property interests each represent exactly the same value. They are of the same denomination; they literally have a common denominator, each sharing the same degree of profit or loss.

So these units of property rights have the characteristic of fungibility; one unit is exactly the same as another. In the case of commodities this arises out of grading for purposes of purchase and sale; one bushel of wheat of a given grade is the same as

another; so of bales of cotton, of pounds of metal. With securities no question of skill in the grading arises. We have a mathematical division of the one set of rights. This fungible quality makes possible organized commodity and securities markets or exchanges. A buyer can contract, not for the one and only thing, but for a thing of a given kind. Delivery of one unit of interest is the same as delivery of any other unit of interest of the group class.

With these fungible units of proprietor (stocks) and creditor (bonds) property rights we have a possible acceleration of changes of ownership and in membership of the groups. Stated in another way, we have the possibility of a rapid shifting of risks and benefits. If a course of market dealings arises, the unit of property has a swift cash conversion value. Its owner may readily resume the cash power to command the uses of wealth. Development of this fluidity has created a new set of problems in the economic organization of a society based on private ownership and freedom of enterprise and competition.

THE INCORPORATED INDIVIDUAL OR PARTNERSHIP ENTERPRISE

Though the need for an instrument through which a large group could efficiently conduct joint enterprise caused the development of the private corporation, merely incidental aspects have often resulted in the frequent use of the corporate form when no large group is necessary. We have already indicated the possible corporation with only one stockholder. An individual may incorporate his business to gain the advantage of limited liability — limited to his original investment — an advantage not enjoyed as an individual or a partner. He often abandons the advantage at the moment when it might be useful; in practice, when the corporation cannot procure credit on the corporate liability alone, he personally guarantees the obligation. But at the time of incorporation he thinks he will gain an advantage.

No real harm is done. He obtains in the limitation only what, excepting, as we shall see, for tort liability, he could, in theory at least, contract for from those who deal with him.[1] And since, in the case of incorporated individual enterprise, the owner is quite likely to be himself the actual human being committing the tort,

[1] Practically, limitation of liability by contract is not feasible.

and therefore personally liable anyway, the limitation of tort liability is often of reduced importance.

An individual enterpriser may seek another advantage by incorporating: the creation of a state of affairs which can be carried on more readily in the event of his death. He contemplates the probability of loss on a forced liquidation. If he dies intestate, his administrator has no authority to continue the business. About the best the widows, heirs, and next of kin can do is to accept interests in the going concern in lieu of liquidation, and form a perhaps ill-assorted and incompetent partnership. By will the owner can give his executor authority to carry on. But an executor acts under great handicap. Incorporating gives very real advantages for avoidance of liquidation on death. A continuous functioning mechanism exists for transfer and sale of stocks and bonds. Widow, next of kin, and legatees can, under provisions of a will, or by agreement, take their proper pro rata of the shares.

This benefit of incorporation becomes more pronounced in the case of a partnership enterprise, which is by law dissolved in case of death of any partner and must be liquidated. Furthermore, the addition or withdrawal of a partner requires liquidation of the old partnership. There is no such thing as transfer of a partnership interest in a going concern by sale without the consent of all partners and liquidation of the old and formation of a new firm. This often results in loss of good will, etc.

DISADVANTAGES OF INCORPORATING THE INDIVIDUAL OR PARTNERSHIP BUSINESS

To gain such corporate advantages, an individual or partnership undergoes certain disadvantages pertaining to the corporate status. Increased burdens of taxation, burdens of state-required corporate reports, burdens of establishing and perpetrating evidence of the authority of corporate agents — all these accumulate a load of labor and charges. In practice the owners of small scale enterprises often go on doing business as if the corporate form did not exist, and frequently get into difficulty in so doing. They fail to hold annual or other stockholder meetings; they do not hold directors meetings; they often forget to file corporate returns, and sometimes suffer severe penalties for such failures. They keep no proper corporate records. Sometimes the corporate organization has to be completely reconstituted in order to carry through the

procedure to dissolve and get off the hook of corporate franchise tax liability to the state.

Mere pride in having a corporation may supply the motive for organizing in this form. To the ignorant and inexperienced a corporate name may present an appearance of grandeur. Often there is loss of credit standing with suppliers, customers, and banks because of limitation of liability.

No one should incorporate unless he is willing to undertake the burden of ascertaining and sustaining the responsibilities involved.

USUAL DEFINITIONS OF A CORPORATION

We have briefly considered the corporation from the viewpoint of the need out of which it arose — the need for a means by which a larger group could carry on a joint business. Let us examine some of the usual statements of the characteristics of this instrument society has devised.

There is the much quoted definition of Chief Justice Marshall in the Dartmouth College Case.

> A corporation is an artificial being, invisible, intangible and existing only in contemplation of law. Being the mere creature of law, it possesses only those properties which the charter of its creation confers upon it, either expressly or as incidental to its very existence. These are such as are supposed best calculated to effect the object for which it was created. Among the most important are immortality, and, if the expression may be allowed, individuality; properties, by which a perpetual succession of many persons are considered as the same, and may act as a single individual. They enable a corporation to manage its own affairs, and to hold property, without the perplexing intricacies, the hazardous and endless necessity, of perpetual conveyances for the purpose of transmitting it from hand to hand. It is chiefly for the purpose of clothing bodies of men, in succession with these qualities and capacities, that corporations were invented, and are in use. By these means a perpetual succession of individuals are capable of acting for the promotion of the particular object, like one immortal being.[1]

And consider this part of a definition from *Corpus Juris.*

> * * * It is purely a creature of law and can exist only by authority of law, and it possesses such powers only as are expressly or impliedly conferred on it by the law. As it is impersonal and exists only in contempla-

[1] *Dartmouth College v. Woodward,* 4 Wheaton (U. S. 1819), 518.

tion of law, it can act only through its members as a body of its duly constituted officers and agents; but their acts on its behalf, when within their authority, are the acts of the corporation as a distinct legal entity. The ordinary powers of corporations are: (1) Perpetual succession, (2) to sue and to be sued, and to receive and to grant by their corporate name; (3) to purchase and to hold lands and chattels; (4) to have a common seal, and (5) to make by-laws. Some of these powers are incident to the corporation, but they are all, generally, expressly given by statute in this country. These powers, however, are not all essential to corporate existence, for, as we shall hereafter see, the period of a corporation's existence may be limited. * * * The only essential attribute of a corporation is the capacity to exist and to act, within the powers granted, as a legal entity apart from the individuals who compose its members; and this is the characteristic which distinguishes a corporation from other associations. In the absence of this characteristic there is no corporation.[1]

Just what does all this mean, and why are these attributes advantageous? We will consider the matter a little in our next chapter — "What Is a Corporation?" Probably the layman will find it somewhat legalistic. Nevertheless, if he will plunge in and swim through, he may emerge with some misconceptions washed off.

[1] *Corpus Juris*, Vol. 14, Corporations, Sec. 3, p. 51.

CHAPTER II

What Is a Corporation?

If two or more men agree to engage in an enterprise together, what shall determine the acts to be done in its pursuit? A group does not have a will. Individuals have wills. When men associate, their wills do not merge into a single group will, and they do not create a group will in addition to the individual wills. But when men unite for endeavor they must find some way by which acts may be done as if there were a single will determining those acts. Though the men in association may not in the least agree on what action is desirable, nevertheless, for the conduct of enterprise, action authoritative and binding on the group must take place. If we turn to physics for a metaphor, we may say that the act done manifests a resolution of the forces of the individual wills.

CORPORATION A SOCIAL INSTRUMENT

One might speak of a business corporation as a social instrument. It is one of the tools by which society accomplishes its economic purposes. Through a corporate mechanism a resolution of individual wills is effected and action follows with sufficient speed for the conduct of the enterprise. We feel and profess amazement at great discoveries and inventions in the field of the natural sciences. We feel it is by this means chiefly that men are adapting themselves to their environments, developing their social relationships, and achieving their economic ends. These discoveries and inventions are often dramatic. Their final attainment usually focuses in some individual, who affords the hook of a personality for our minds to hang on to. Such discoveries and inventions are vivid and appealing. They have wrought tremendous changes in human affairs, and have proceeded with a special rapidity during the past century. We would not decry or minimize the sense we have of their profound importance, nor the admiration we feel for the men who bring them about.

DEVELOPMENT OF INSTRUMENTALITIES OF SOCIAL ORGANIZATION

But continuously society is developing the instrumentalities through which, in its political, economic, and social organization, it deals with the objective matters of its existence. In its economic aspects society must devise and declare or choose the manner in which it will carry on the processes of production and distribution. Its inventions for this purpose are profoundly important.

This kind of invention, however, results in no tangible object. It does not directly produce anything that can be seen, smelled, touched, tasted, or heard. It does not manifest itself in any form of physical energy. It consists of ideas, concepts. Because it lacks any kind of physical appeal, men do not sense the dramatic in it; they do not seek its personification in individuals. Yet such concepts as the negotiable instrument, bill of lading, warehouse receipt, generally the mechanism of credit, the stock and commodity exchanges, the forms of insurance, and other corresponding instrumentalities are the result of inventiveness to meet the needs of organized society, and are no less remarkable, significant, and influential than scientific and mechanical invention and discovery.

Business men engaged in carrying on the affairs of the community — bankers, lawyers, judges — develop the ideas which become the instruments of society in much the same manner as scientists and inventors develop the ideas which become known as discoveries and inventions in the fields of chemistry, physics, and mechanics. But in the case of these social instruments, the names of individuals never become attached to them, except perhaps those of a few judges known to the more scholarly in the legal profession. There is no patent office to give such individuals special rewards. A need gives rise to an idea; and once the idea has served, it becomes the common property, an addition to the public stock of useful concepts.

In this chapter we shall give to some of these juristically recognized concepts such consideration as will present the problem of effective action in group enterprises.

ARRIVING AT AN EFFECTIVE WILL TO ACT

Obviously when an individual conducts his own affairs we have a real will, making decisions and putting them in operation. But

if two or more people wish to join in enterprise, what shall determine action, and with what consequences to the members of the group and those with whom they deal? The English body politic, working out the answer to this double question, developed the English law of partnerships, which, after generations of trial and error, became embodied in court decisions. These precedents were transplanted in the American colonies and became the Common Law in each State. Partnership law is but a branch of contract law, for partnerships exist by agreement of all the partners which the Common Law gives the force of a contract.

If the wills of the partners are in full accord, no question arises. But if they differ, and their contract among themselves does not provide for the exigency? Then under the early Common Law rule no action could result. The wills of all the partners had to be in agreement.[1] Under the modern development of partnership the agreed wills of the majority govern.[2] So the partnership form of organization no longer presents as great an obstacle to action as previously.

HOW DOES ONE DEALING WITH A PARTNERSHIP GROUP KNOW ITS EFFECTIVE WILL?

How is a person, not a member of the partnership but dealing with it, to know when he has an authoritative agreement? The concept of contract requires a meeting of minds, or the legally recognized equivalent. If three persons are on one side of a bargain and are all present and assenting or all sign a written form of agreement with one person on the other side of the bargain, the party of the second part knows that the minds meet, three on one side and one on the other. But if the group can enter into only those transactions on which they all agree and to which they must all indicate their assent, it could not compete in the enterprise with individuals who can each act promptly on the formulation of his single will. If the actual agreement of all the partners were required, an individual with whom they would deal could not safely act until he knew that the partners were in agreement among themselves. Under modern conditions such a situation would be prohibitive of group enterprise.

So we have the concept that if a group undertakes to carry on

[1] W. S. Holdsworth, *A History of the English Law*, Vol. VIII, p. 202.

[2] *Corpus Juris*, Vol. 47, Partnership, Sec. 226, p. 785.

an enterprise, anyone dealing with it may assume that if a member of the group *purports* to deal on behalf of the group, the act of the member represents the will of his fellows. That is, we have the doctrine that each partner is the *general agent* of all his associates in the group enterprise, *provided he acts within the scope of the enterprise.* This proviso of action within the scope of the enterprise affords some protection to the co-partners — their fellow cannot commit them in entirely unrelated affairs. It puts some burden, however, on the person dealing with the partnership. He must know the purpose of the joint enterprise and that the intended act is within the purpose.

HAZARDS OF THE PARTNERSHIP FORM OF GROUP ORGANIZATION

If the partner's act is within the scope of the enterprise and does not in fact represent the joint will of his fellows, they are, nevertheless, bound by it as if it did, even though he acted against their express will, unless the person dealing with him actually knew of the limitation on the partner's authority. This is the practical solution found in partnership for the difficulties inherent in group action. It gives rise, however, to a great difficulty of joint enterprise in the partnership form. Since each partner is fully responsible for commitments made by his associates, a man hazards his entire fortune on their integrity and ability. He can reasonably join only those whom he knows well enough to be willing to chance this risk. No one can know many such people.

RIGIDITY OF THE PARTNERSHIP GROUP

The tremendous power of a partner over the fortunes of his associates not only limits the formation of groups for business, but makes the partnership group rigid. In the absence of agreement in the partnership contract, no additional member may be admitted against the will of any partner, and the withdrawal or death of a partner dissolves the group and brings the joint enterprise to an end.

FLEXIBILITY BY CONTRACT

But by agreement the persons associating for business may formulate the partnership group on substantially any principles they

see fit. For example, they may agree that the attempted withdrawal of a partner shall not end the enterprise. That is, they may agree that the partnership shall continue for a stipulated period. Though this is an agreement that the group as formed shall continue for the period, and the withdrawal of a partner would be a breach of the partnership contract, still the partners cannot compel the specific performance of the service of one of their number. The effective value of the agreement for a partnership term, besides the coercive influence of liability for damages for breach, is that it assures the continuance in the enterprise of the capital of the partner wrongfully withdrawing, and enables the continuing partners to go on with the enterprise. Such a provision is highly important with most businesses requiring substantial capital. It takes time to get them under way and bring them to a point of profit making.

CONTRACT MAY AMONG PARTNERS THEMSELVES LIMIT THE GENERAL AGENCY OF EACH

Partners may agree among themselves that only a certain one or several of them shall in fact enter into transactions for the enterprise, the others furthering the business only with their capital or with solely administrative services. This might seem a solution of the problem of hazarding one's entire fortune to the integrity and ability of another. All members of the group might have confidence in one or more of their number sufficient for the hazard of fortunes, without each having such confidence in all the others. Though the members of the group so agree, what if an unauthorized member does in fact undertake to enter into transactions on behalf of the group? If he is acting within the scope of the partnership enterprise and the person with whom he deals does not in fact know of the limitation of authority agreed on among the partners, the partner acting in violation of this agreement nevertheless commits his partners.

Broadly speaking, these agreements of partners among themselves do not affect those with whom the group deals. Such outside persons are not parties to the partnership agreement and, in absence of specific knowledge, are in no way bound by it. An agreement between A and B does not ordinarily affect the rights of C. We are not concerned here with exceptions to this principle.

CONTRACTING FOR LIMITATION OF LIABILITY

Can the members of a group limit their hazard of fortune to that part of their wealth which they specifically commit to the partnership enterprise? Speaking broadly, men may in *contractual matters* contract to limit their liability, and there seems no reason in the nature of things why, if a man, not a partner, but dealing with the partnership, agrees that, in case of breach of contract by the group, he will not seek satisfaction beyond the partnership assets, he should not limit his rights to that extent. But for the partners to gain the benefit of such limitation of their liability, it must be expressly contracted for in each transaction. Though the partnership agreement may provide that it shall be contracted for by any member dealing on behalf of the group, still the articles of partnership do not bind those who are not members, and if a member wilfully or negligently failed to limit liability, all his co-partners would have their entire fortune at the hazard of the transaction. They would, of course, have a right of action against their wrongfully acting partner for their losses.

A statutory partnership may, however, have one or more *special* or *limited* partners, whose liability for partnership obligations is limited by the group agreement to their original or a fixed contribution. If notice of this limitation is advertised to those doing business with the group, and the special partner is always listed as such on all stationery, and in other similar manner, the limitation becomes binding on all dealing with the group, whether or not they have specific notice thereof.

CANNOT CONTRACT TO LIMIT TORT LIABILITY

In one direction, however, limitation of liability by contract is not effective. If the associates in conducting the joint enterprise injure one not a member with whom they have no contractual relationship, obviously all the partners are liable, and also, obviously, since there is no contract limiting liability, they are liable to the extent of their entire fortune. Even if they have a contractual relationship of limited liability with a person who may suffer damages as a result of their negligent or otherwise tortious acts, such attempt by them to contract against liability, or for a limitation of liability, for those acts or omissions which the law classifies as torts, would not be successful. The welfare of the community re-

quires responsibility for acts of this character, and, as a broad general principle, men may not legally contract themselves out of such responsibility. Here is a great obstacle to joint enterprise, further putting the fortunes of each member of the group to the hazard of the integrity and ability of all his associates in their acts or omissions on behalf of the business, and in their selection of employees who may wilfully or negligently commit torts in the course of their employment.

FURTHER CONTRACTING FOR FLEXIBILITY

We have considered the rigidity of the partnership group, and have seen that in the absence of agreement a new member cannot be admitted without the consent of all the partners. Can the member at the time of entering into association agree to the contrary? If a member has committed his capital under a term contract, can he be permitted to liquidate his asset and withdraw from further liability by transferring his partnership interest to another? Again, there is nothing in the nature of things to prevent people from associating on such terms as they see fit. So it would seem that the group might be formed, and its enterprise continue, though the group conducting it change.

LIMITATION OF EFFECTIVENESS OF CONTRACTS ALLOWING CHANGES IN THE PARTNERSHIP GROUP

But what about the rights of non-members dealt with in the course of the business? Those who have had actual dealings with a partnership are entitled to assume, unless they have notice to the contrary, that the persons carrying on the enterprise continue the same. And, indeed, it may be necessary to advertise the change in the group in order to free the outgoing member from liability to those who deal with it in the future without actual notice of the change. So under the principles of partnership, though the agreement may provide for changes in the group, actually effecting them is not easy. In fact, what results is the creation of a new, rather than the continuation of the old, partnership group.

Even on such a withdrawal a retiring member does not free himself from existing liabilities. Those who dealt with the group while he was a member dealt with him, and he cannot be freed from his contract without their consent. The continuing partners may agree with him to assume all liabilities and indemnify him, but

this agreement cannot free him. Here again, however, the partners on entering into a contract with an outside person might have contracted with him, if he would agree, that an outgoing partner should be released under such circumstances. However, the negotiation of ordinary commercial contracts does not usually permit of such detailed contractual relationships. They are impractical in a competitive field.

By articles of association partners may accomplish much in the formulation of the group and the control and management of the joint enterprise in accordance with their desires. But their agreement cannot affect persons not members of the group, who have not specific knowledge, for such persons are not parties to the agreement. Agency, however, is a question of fact, and if the outside person has knowledge of a fact of limitation of agency by agreement of the partners, presumably he would be bound by it.

JOINT STOCK COMPANIES AS BEGINNING OF ESCAPE FROM DIFFICULTIES OF PARTNERSHIP GROUP ACTION

As men sought, somewhat in vain, for greater safety in association in larger groups from the dangers of each member's power to bind for the entire group, and by their agreements attempted to limit to a few the authority to do business, and as they sought for greater flexibility by providing for the transfer of participations of members, groups which came to be called joint stock companies gained some special juristic recognition. This recognition, however, need not have been founded on anything more than the fact that the nature of the articles of association was notorious and made public — that they limited the agency to certain members, that they provided for changes in the membership of the group by transfer and sale, and that this notoriety should put a person dealing with the group on inquiry for each transaction as to the facts of agency and the membership of the group. This recognition, however, substantially increased the ease of group action. Still it did not affect everything lying in the field of privity of contract between the group and those dealing with it. It did not, for example, bind a person dealing with the group so as to make a part of his contract with the group a provision of the articles of association (or partnership contract) that all contracts made by the partners on behalf of the group should limit liability of the group to assets contributed to the enterprise.

IDEA OF A FUND FOR CREDITORS

In fact, with respect to the Common Law, the idea of assets committed to the enterprise is one affecting only the members of the group. That they should so commit assets is merely their agreement among themselves. Persons not members of the group are not parties. Furthermore, if the group should endeavor to contract for a limitation of liability to assets committed to the enterprise, presumably one with whom it dealt would so contract only on condition that the assets remain committed as long as the group had any liability to him. In short, we have at Common Law no concept of capital stock of the enterprise. As far as creditors are concerned, the members of the partnership group can withdraw capital from the enterprise, for the members are liable to the extent of their assets. Persons dealing with the group are dealing with the persons of the group, and primarily are not contracting with relation to any particular assets of those persons. Nevertheless, the rule of partnership law marshaling assets on insolvency, namely, that partnership assets shall first be applied to partnership liabilities, presents the beginning of an idea of a group fund for the benefit of creditors.

The joint stock companies issued participation certificates which on their face were made transferable by endorsement from one owner to another. Though they are spoken of as a share of stock, the stock is not capital stock in the modern corporate sense of limited assets to be held for the satisfaction of the claims of persons not members of the group. At Common Law the joint stock company could buy its own shares without limitation, thus affecting a distribution to members of assets committed, for members remained fully liable to creditors. A corporation may legally do so only out of surplus. Otherwise there may be fraud on the creditors. The shareholder, through the purchase of his stock, has received a distribution from the fund for creditors. The corporation has received no value except the right to admit a new member. Unissued stock gives this right, but is not an asset.

Statutory enactment in relation to joint stock companies began early, so that it becomes necessary to scrutinize court decisions carefully to discriminate between the Common Law doctrine with which we are at the moment interested and decisions affected by statutes which recognized such companies and extended benefits to them not enjoyed by partnerships.

GAP BETWEEN PRIVITY OF CONTRACT AND BEING BOUND TO TAKE NOTICE

In the process of trial and error by which society develops its instruments it then was branching into a new experiment in formulating a method of group action in business enterprise — the corporation. There seems to be no reason why in the nature of things our society should not, by the Common Law method, have bridged the gap of privity of contract, and have provided that men might join in enterprise under articles of association of which persons dealing with the group would be bound to take notice, and which would be binding on them in their dealings with the group.

POLITICAL ORIGINS OF THE CORPORATION

We may surmise, however, that this process did not take place because the development of the social instrument of the private business corporation has a line which leads back to the public corporation — the gilds especially, the municipality in one form or another, the church in the conduct of its affairs, as in reality a cognate branch of the totality of the state, carrying on its business through the corporation sole of the bishop, and perchance the university as a corporation, and later the organization of the great colonizing and trading companies like the East India Company and the Hudson Bay Company with political as well as business functions. In all these instances the corporation exercised a political function, and had delegated to it some of the sovereign authority of the state. This idea may extend to one of the early uses in the United States of the corporation form for the construction and maintenance of toll roads, bridges, and canals, which, being public highways, may be regarded as giving a political aspect to the corporation. Of course an exercise of sovereign power,. of a political function, would require a delegation from the sovereignty. Before the time of these public or quasi-public enterprises the economic organization of society had been such that private enterprise on the existing scale of size could accommodate itself to the limitations of the partnership form. This, however, in time came to press for change through at least some recognition of the joint stock company as varying a little from the older ideas of association for business.

It was only natural, when the grants by the sovereign of author-

ity to exercise public functions in connection with private enterprise, grants which provided methods of operation desired, were found to work effectively in business affairs and to permit escape from some of the difficulties of group enterprise under the only Common Law principles so far developed (those of partnership), that incorporation by government charter should come to be sought as the open road, which men followed instead of treading out new paths at Common Law as they did in other fields. So, as the corporate form came to be sought for purely private enterprise, the idea of a grant of special privilege adhered to it, and clings to this day.

OWNERSHIP OF PARTNERSHIP PROPERTY

Though we have seen some of the difficulties of joint enterprise for groups of more than the smallest size, it may be appropriate to mention other difficulties for the light they throw on the problem of group organization for business. In association enterprise, who owns the assets employed in the business? The answer seems obvious — the members of the group, of course. But that obvious fact starts a train of difficulties. When ownership is to be transferred the transferring must be done by the owners. If several persons associate for the purpose, say, of retail merchandising and acquire a stock of goods, the course of selling the merchandise involves no actual difficulty. All the associates own each yard of cloth or pound of sugar, but each has authority from all the others to sell. For a sale of movable things like the cloth or sugar the law requires no special formality to be performed by the owners, and anyone in fact having authority may transfer ownership for the group as readily as he can transfer things owned by him personally.

But for real property (land) the law, representing the interest or policy of organized society, has required the formality of written contracts or deeds expressing the will of the owner, and for land owned by more than one individual, there must be explicit evidence in some way formally that all owners have freely and legally transferred the ownership. So if our retail merchant partners buy a building in which to deal in their goods and afterwards wish to sell it, they must join in the deed of conveyance. This may be no great difficulty for a partnership of two or three. But it would be for a partnership of two or three hundred, especially when there may be disagreement as to the sale.

OWNERSHIP ON DEATH OF A PARTNER

Another question arises along this line. If all the partners own each thing in the business, what happens to the ownership of a partner who dies? Here the law had developed principles in a limited measure favorable to group enterprise. So far the use of the words "title" and "property" have been avoided by the use of the ambiguous word "ownership." Title is like a geometrical point, merely an expression of relationship. As the geometrical point expresses relationships in space, so title expresses relationships of human beings to each other with reference to things. To say that title to something changes is simply a short method of expressing the fact that the relationships of human beings with respect to that thing have changed. For a group of two or more persons owning property our law worked out two solutions with respect to title in the event of the death of one of the group.

NATURE OF TENANCY IN COMMON

Depending on the agreement of the parties to a transaction at the time of the acquisition of property or, in the absence of agreement, depending on the nature of the group and the circumstances of the transaction, the ownership by the group might be, in law language, either a tenancy in common or a joint tenancy. Wherever, in the event of the death of one of the group owners, his legal representatives, his heirs or next of kin, can by agreement or by law come into the title in the place of the decedent, and for a sale of the thing owned would have to join in the transfer, the situation is called a *tenancy in common.* Besides the fact that these new members of the group were not selections of those who originally associated themselves in the ownership, and therefore might not be satisfactory to those associates, some or all of the new members might be infants or legally incompetent, and by their inclusion seriously embarrass group action.

NATURE OF JOINT TENANCY

When, however, on the acquisition of property by a group, agreement or operation of law provides that the legal representatives of a deceased member shall not be admitted in the title, but that the surviving members shall have complete dominion over

the property, and they alone have the power to dispose of it, the situation is *joint tenancy.* This is essentially the case with property acquired by persons associated as partners for the conduct of the business to which the ownership of the property is incidental.[1]

In the partnership joint tenancy, however, though the surviving partners take the legal title, and alone can transfer the property, the legal representatives do not lose the value of the deceased partner's share. The surviving partners in effect become trustees of the deceased partner's interest for the benefit of his estate.

So the property right of a partnership interest has an odd duality. For the purpose of legal title it has the characteristics of a joint tenancy; for the purpose of beneficial enjoyment it has the characteristics of a tenancy in common. This telescoping of two ideas helps make Common Law group conduct of enterprise possible.[2]

[1] This discussion of the joint tenancy aspect of partnership title is near enough to accuracy for the purposes of this chapter. As further explanatory the following quotation from *Corpus Juris*, Vol. 47, Partnership, Sec. 607, p. 1040, will serve: "The entire title to partnership personalty does not, under the common law doctrine of survivorship applicable to joint tenancy generally, vest upon the death of a partner in the survivor or survivors; and although they are sometimes stated to take by survivorship, the legal title becomes vested in them only for the purpose of winding up the business and settling the partnership affairs. However, it is generally held that the survivor does become the legal owner of the assets of the firm or of its personal property, including its choses in action, for purpose of adjustment or liquidation of the partnership affairs, this legal ownership carrying with it the right to control and dispose of such assets within the limits of good faith; and it has been held that in law the ownership is absolute, although it may be somewhat qualified in equity, or the title may be considered but an equitable one. In the absence of agreement otherwise, the ultimate interest of the deceased partner passes to his personal representatives or to his devisees; but neither the representatives, heirs nor devisees are entitled to any part of the assets until firm debts have been paid, or, as stated in the case of devisees, until the accounting and final settlement of the partnership affairs."

[2] The writer once drafted an agreement for an agent to manage investment funds of a number of individuals commingled in a single fund for management — a group situation. Each member of the group is a principal. The doctrine that the death of a principal generally revokes the agency presented a difficulty. The writer relied on the further doctrine of exception: that if a power is coupled with an interest, the power survives the death of its creator; and hopes in case of necessity that a court, on an invocation of this doctrine, would find the facts in the particular case such as to create the requisite interest in the agent, who, among other facts, was to be compensated out of profits. The problems presented by the commingled fund especially impressed him with the difficulties of group organization at Common Law, and with the value of the statutory solution through incorporation. It seems rather a pity that penalty taxation has made the solution too expensive to adopt for many situations.

NATURE OF OWNERSHIP TENDS TO RIGIDITY OF PARTNERSHIP GROUP

This principle of joint tenancy is obviously helpful to the conduct of group enterprise. But what about a change other than by death in this group to which the principle applies? Difficulties of ownership still hamper the formation of what we may call the mobile group, an association in which the membership may freely change. Must a person on transferring his membership specifically also transfer his share of ownership in the association property to what is in fact a new group formed by his retirement and the admission of the new member? Specifically, if the group owns land must the retiring member give a deed conveying his interest to the new group consisting of the continuing members and the new member? If, on forming their association, the members wish to provide not only that a partner may transfer his entire interest and retire, but also that he may transfer part of his interest in the enterprise, admitting a new member and continuing himself a member with a reduced interest, we see that the situation with respect to title to the group property becomes still more complex. Obviously this matter of title to property tends to rigidity in the group. The corporate concept effects a solution.

INTERJECTION OF THE TRUST IDEA IN THE ENDEAVOR TOWARDS FLEXIBILITY

Endeavor for the formation of larger business groups with shifting membership found at least a partial solution in the law — the equity ownership recognized in our juristic system. It developed principles under which one person can have the legal ownership of property and another have the essential benefits of the ownership — in short, a trust, under which one has title and control in law, but in equity another is assured of the benefits. We shall consider briefly the development of this distinction between law and equity in later chapters on mortgages. The idea of a trust is currently familiar enough to laymen for just a reference here. To overcome some of the difficulties of ownership in group enterprise, Common Law joint stock companies provided that trustees, who would be some or all of the active managers or agents of the enterprise, should have the legal ownership of all the property used in the group business. This made it possible to

provide for the transfer by the owners of the beneficial interests of their shares in an enterprise without becoming involved in the difficulties of title to property owned by the trust. Why this putting of group property in trust for purposes of ownership did not sooner lead to the idea of a trust for the management of the business is not easy to perceive.

Perhaps the distinction is this: the trustees under a joint stock company association, through holding the property in trust for convenience in transferring the property itself, and even more to avoid property difficulties in the transfers of membership or shares of interest, are still in conducting the general business of the group regarded as agents for their associates in the membership, so that contracts made by these agents are contracts of the members, with the full consequences of liability of the members. In the still later development of the *business trust* the law considered the contracts as those of the trustees themselves and the liabilities theirs (subject to indemnification limited to the trust property), and the members of the group who were not trustees are entitled to benefits without liability beyond their contribution to the trust fund employed in the business.[1]

DIFFICULTIES IN GROUP ACTION ARISING OUT OF THE QUESTION: WHO CAN SUE AND BE SUED?

How legal rights and duties are to be enforced through the sanctions of the law is another difficulty of group conduct of business under the Common Law. Rights at Common Law are the rights of human beings, and duties the duties of human beings. Just as a group has no will as such, but each of the persons who are members have wills, so each member has rights and duties, which may arise, however, out of the conduct of an enterprise by them in association. Again we find ourselves in a maze of difficulties. X contracts to deliver a barrel of flour to a group at its place of business. He has one duty to perform, namely, to deliver the barrel of flour; but he owes that duty to several people. Conversely, the several people jointly have the one right, though each has the same right, namely, to have one barrel of flour delivered at the

[1] It is part of the illogic of the law that it has always in its recognition of trusts ignored its principle that he who has the benefits shall also bear the burdens (*qui sentit commodum, sentire debet et onus*), on which it is insistent in agency.

specified place by X. Does X in contracting with the group subject himself to action by each member for breach? Or, to state the other side, may each member bring legal action on breach of the one duty? On the other hand, the members of the group owe one duty, namely, to pay once only the stipulated full price for the flour. There is no duty to X that each pay his proportion of the price to the seller. It is the duty of the members to each other to contribute their respective proportions to make up the stipulated price. Though each of the group of buyers has a duty to pay the full price, this does not result in the seller's acquiring a right to be paid many times. As a solution of these problems, the partners must all join in a suit against X to enforce their rights, which each acquired, but acquired in association, arising from the breach of X's duty to each of them; and correlatively, a person acquiring a right from each of the several in association must join them as defendants in an action on breach of the duty they owe him.

If the number of members in the group becomes large, and especially if it is constantly changing by transfers, requiring a person dealing with the group to ascertain the members and join them as defendants in bringing action, the situation creates an obstacle to the conduct of group business. The difficulty the other way of all the members of the group joining as party plaintiff is perhaps not as great. But a complaint beginning with several hundred plaintiffs would at least be formidable.

LIMITED LIABILITY

If each and every member of a group is not willing, no matter how small his interest in the group enterprise, to hazard his entire fortune to the faith and judgment of each of his associates, he may, as we have seen, stipulate with the others that only certain members shall be agents of the group, and in this way limit the agency to those he is willing to trust. We have seen that with the development of larger business groups in the form of unincorporated joint stock companies such a limitation apparently came to be considered so notorious that all persons dealing with the group came to be held on notice of it. We have considered the possibility that the group might limit the authority of its designated agents, directing them to contract with non-group members only with a stipulation limiting liability of the group members (except tort liability which by law cannot be contracted away) to capital con-

tributed to the enterprise. Might not such a stipulation, if generally made, have come in time to be regarded as so notorious that the world would be regarded as on notice of it? Though this idea might have developed, it did not in fact evolve.

Such a limitation of liability to the group assets finally resulted from incorporation. When business enterprisers pursued the course of incorporation, presumably for the most part because they sought governmental powers, they also in fact obtained as an incident this limitation of liability. But the members of a group associating as a corporation might also agree that they would make with limitations contributions for the enterprise beyond their original payments — in other words, become assessable. In such a situation, persons dealing with the group might pursue this corporate power of assessment, which is in effect an asset contributed to the enterprise. As this possibility was established it became customary to enter among the provisions of the corporate charter express stipulation against assessment.

FORMS OF THE BUSINESS CORPORATION

Business corporations took their earliest shape in the form of the regulated company, the individual numbers of which did business on their own account under the rules and conditions and with the privileges of the corporation. The gilds and early trading companies represent this type of corporation. It was somewhat as if the Stock Exchange were incorporated with a monopoly of the business of acting as brokers in the trading in securities, but each member still conducting his own brokerage business, risking his own capital under his own control with full personal liability. Under such conditions the corporate limitations of liability would not be of great importance.

CHARTERED REGULATING COMPANIES

Municipal corporations, however, presented another aspect. They were conducting municipal affairs for the benefit of their citizens. Though it was early argued that, since the king could tax the citizens, the corporate liability was not limited to the group or corporate assets, the court held that a power in the king's subjects to reach personal assets of the citizens could not be inferred from the king's power to do so.[1] However, a procedure de-

[1] W. S. Holdsworth, *History of English Law*, Vol. III, p. 484.

veloped under which an essentially unlimited liability through taxation now exists upon the citizens of a municipality. If now a municipality owes debts to individuals, they call upon the sovereign to exercise the sovereign power for their benefit, and procure a writ of mandamus ordering the agents of the municipality to levy taxes for the satisfaction of the debt. This result links up with the idea that if a corporation has the power to assess members, the corporate creditor can compel the exercise of that power to satisfy his claim. We are not concerned here, however, with the municipal situation.

CHARTERED JOINT STOCK COMPANIES — AT FIRST SERIES OF JOINT VENTURES, THEN CONTINUOUS ENTERPRISE

Out of, or at least subsequent to, the first development of the incorporated regulating company, the incorporated joint stock companies developed with a special charter from the Crown and limited liability in each case. In these latter the members contributed capital, which their agents used in the conduct of the enterprise. At first the common understanding was the conduct of a series of joint ventures, each in turn being wound up, and a new one, to which new capital was contributed, embarked upon. Such transactions did not call for a clear distinction between capital and profits in the distributions. Liabilities of each venture were liquidated, and the balance, capital and profits, or capital less losses, distributed. It was only as capital came to be used in continuous enterprise that, from the viewpoint of the creditor, the distinction between capital and profits became important, with the consequent development of rules intended to preserve capital for the benefit of the creditor.

UNCHARTERED JOINT STOCK COMPANIES — RESULTING IN STATUTORY REGULATION

As the growth of incorporated joint stock companies, each one with its special grant of a royal charter, took place, promoters came to launching joint stock companies without procuring a charter. The investing public apparently often failed to distinguish between the incorporated company with its limited liability and the unincorporated company with its unlimited liability. The collapse of the South Sea Bubble in 1720 led to regulatory legisla-

tion of such unincorporated companies, which had developed extensively amid vast speculation and huge public losses.

TRUST FORM OF GROUP ENTERPRISE

While discussing the general problem of group enterprise, we have to consider one other form. Title to assets of a large group partnership, especially real estate, has, for convenience in handling, often been vested, by deed of trust, in less than all of the partnership group, in trust for the partnership. We come now to the practice of such vesting of title together with the grant of full authority to conduct the business. In connection with such a trust we must note here that under the principles of equity in English jurisprudence we can have the legal title to property and responsibility for the property in one person who, however, must pay the rents and profits to another. The person holding legal title is the "trustee" and the person to whom he must account for the income is the "beneficiary." By a declaration of trust it is possible for an individual called the "settlor" to transfer the legal ownership of his property or funds to another, the "trustee," for the trustee to invest and manage and pay the income and profits to the settlor or the person or persons designated by him as beneficiary.

In Massachusetts, difficulties in the way of incorporated real estate enterprises led to the endeavor at group ownership and management of real property in the form of such a trust, with the trustee authorized to conduct all the affairs of the premises. In this form the beneficiaries escape liability beyond the loss of their capital contributions provided they have surrendered full control of the property to the trustee. Since in the law such trustees are the legal owners and the persons responsible for the burdens of ownership, the beneficiaries escape even tort liabilities. This a partnership could not do. The trustees, moreover, may protect themselves from contractual liability by expressly stipulating for its limitation to the trust assets, and from the ordinary tort liabilities of business they can in fact protect themselves by insurance.

WHEN DOES A TRUST BECOME A BUSINESS ASSOCIATION?

This plan gives rise to a series of questions. Primarily, is such a situation really to be regarded as a trust and treated as such or, disregarding its form, is it to be considered as a business associa-

tion and subject to all the principles generally governing incorporated enterprise? Inquiry runs along two main lines: (1) Is the situation essentially an investment or essentially a business? (2) Have the beneficiaries really divested themselves of control, or in fact are the so-called trustees merely agents?

A distinction between an investment and a business is one of degree and not of kind. Ownership of an office building does not require such an amount of labor in management as an equal value of capital invested in the manufacture and sale of machine tools. A distinction is also sought along the line of income and profit: that an ownership to collect income is an investment, but an enterprise to make profits is a business. But the element of profit is seldom completely divorced from income. Is an "investment trust" in which "trustees" buy and sell securities a business? Only the degree of activity with which profits as distinguished from income are sought can mark a difference between conducting a business and holding for investment.

Whether or not the beneficiaries of a "trust" have divested themselves of control is easier to see. If under the declaration of trust the trustees are co-opting, that is, themselves appointing successor trustees to fill vacancies in their number, the beneficiaries do not have control of the management. Such a group is not in essence conducting a business through people fundamentally agents but, by reason of their holding of the legal title, denominated trustees. If the "trustees" are found to be mere agents, the fiction of the trust is ignored and the group is treated as a business association.

TAXATION CAUSING TREND TO TRUST FORM OF GROUP ENTERPRISE

Outside of Massachusetts, where, for reasons peculiar to the jurisdiction, the trust form of group business organization got a start, it did not make much progress in the United States until the World War, when the national income tax assumed proportions and forms which gave an impulse to the business trust. Some enterprisers fled to it in an endeavor to escape the corporate excess profits tax. This was a special tax on profits above an ordinary rate of return on capital in the kind of business in which it was employed. The tax was graduated and ran to high percentages, in addition to the corporate penalty of an income tax of

twelve and one-half per cent on which the shareholder received the benefit of exemption on dividends of only the normal tax of four per cent. If the form of ownership were such that the entire income available for distribution to members of the group had to be reported to the members, and they had to include their entire share in their Federal return of income, and pay a tax on it, then the penalty corporation taxes were avoided, for the organization was a trust and not a corporation.

However, the desire to avoid these penalty corporate taxes conflicted with another desire. If the ownership were in the corporate form the shareholder did not personally have to pay any tax on income available for distribution until it was actually distributed. If actually distributed his personal taxable income might rise into a higher surtax bracket, and he, living in hope that the surtax rates would be reduced, might prefer that the available income should not be distributed for the time being. Nevertheless, the desire to escape excess profits taxes prevailed to some extent in businesses that were or might be exceptionally profitable under prevailing conditions, notably in oil production enterprises.

Such avoidance of taxes penalizing the corporate form brought about changes in the Federal law so that for taxation it treats group enterprises not actually partnerships the same as corporations. With this development the impulse to the trust form of group organization lost much of its force. Since our interest is especially in the corporate group, this mention of the trust group has been made only as indicating its place in the endeavor at group organization for business.

CONNECTION OF CORPORATIONS WITH PATENT RIGHTS AND MONOPOLIES

One of the roots of the modern business corporation seems to run into the same soil as that from which modern patent rights grow. A patent is a grant of a monopoly of a discovery or invention. It might be given to one who found the invention abroad, and wanted advantage from bringing it into domestic use, as well as to one who was himself the inventor. The domestic benefit justified an invasion of the Common Law rule against monopoly. Sometimes a sovereign showed special favor to a subject, and provided him with income by granting him a trading monopoly in which no invention entered.

Such invasion of the Common Law could come only from an exercise of the royal prerogative or by statutory enactment. Early grants of this kind were by exercise of the prerogative. They were obviously special privileges. Grants of this kind might be to individuals and commonly were. But they might be to a group of individuals. In any case business enterprises grew out of them. It seems probable that they had an influence in the development of business corporations. Certainly the *idea* of special privilege by charter grant inheres in them, though practically it has disappeared with the adoption of general statutes permitting incorporation as a matter of form and procedure.

Just as in the case of corporations, however, actuality of special privilege in patents on inventions has also disappeared. Correspondingly the enactment of general patenting statutes, under which all subjects or citizens who can establish the fact of invention thereby obtain the monopoly protection, shows the disappearance of any real privilege.

By way of comment as indicating how far we may go in getting away from the requirements of special grant for incorporation, we now find statutes permitting the incorporation of municipal districts without legislative act in each case. Here we have a grant of undoubted sovereign political power. We have seen that the bestowal of such powers may have had a bearing on the concept of the business corporation as a special privilege. Also we may perchance perceive that there is no ultimate distinction between political and other social relationships. All are forms of duties and benefits of human beings consequent upon their living in an organized society.

CHAPTER III

Formulation of the Statutory Group

In both the grant of patent rights of a monopoly for an invention, and of authorization to a group to conduct an enterprise as a body corporate, the law statutorily has (generally) done away with the necessity for a special grant from the government in each instance and has provided administrative machinery whereunder all who can and will comply with the stated requirements have a right to a patent or to be incorporated as the case may be. Though presumably the law has not abandoned the principle of special privilege in the case of the patent monopoly, in actual practice the principle has lost significance in that case. But in one sense it is very much alive as the basis for a special taxation of corporations, which in effect penalizes the selection of that form of group organization for business.

GENERAL INCORPORATING STATUTES

England has its Companies Act and each State of the United States its general corporation statute by compliance with which a group may engage in business as a corporation. If a group desires to be incorporated by the Government of the United States it may still have to seek a special act of Congress to be passed under some Constitutional power of the Federal Government. Congress, however, has provided for general incorporation of banks under the National Banking Act, and has in its code for the District of Columbia authorized what may be called administrative incorporations for the District in like manner as under the general incorporating acts of the several States. And under the organizing acts, or other source of authority, administrative incorporation may be obtained in the several territories.

A group seeking the benefits of incorporation must comply strictly with the requirements of the general incorporating statutes of some one State. The Secretaries of State, or other public officers

administering them, have no authority to waive exact compliance. Failure to comply with the statute exposes the group to the danger of not acquiring the status of a corporation, though they may believe that they have it, and leaves them in the position of an unincorporated group, in short, with all the liabilities and with other dangers of a partnership. If the statute requires all the applicants to be of the age of twenty-one years, and one of the applicants is not of that age, though he has represented himself as beyond his minority, presumably there is no corporation; at least there is no *de jure* corporation. Correspondingly, if the statute requires certain of the applicants to be citizens of the State, and they are not, presumably there is a failure of incorporation, and so on. The process of incorporation requires care in reading the statute and in carrying out its provisions.

PLACE OF INCORPORATION

When those proposing an enterprise desire the corporate form, one of the problems arising is in what jurisdiction, that is, from what government, the status shall be sought. Solution of the problem generally turns on questions of cost, special privileges offered by the jurisdiction, labor involved in complying with its requirements, coupled with the added costs and labor if incorporating in one jurisdiction will involve the necessity of qualifying to do business in other jurisdictions.

For a State, as a sovereign, can give a group the status of a corporation and authorize it to do business in its own jurisdiction. But if the group as a corporation is to carry on business in another jurisdiction it must obtain the consent of the other jurisdiction. A corporation of a State is a foreign corporation in every other State. But a corporation of the United States created under the Constitutional powers which Congress possesses is not a foreign corporation in the several States. Because of the limitations on the Federal Government by the Constitution, Federal incorporation, except for governmental agencies (including National Banks) is very rare. So a group must weigh the business of incorporation and qualification. Stated in the simplest form, if a group expects to carry on its business entirely in New York, will the burdens of incorporating in Delaware and qualifying in New York be more or less than an offset to the advantages of incorporation in Delaware?

STATUTORY OFFICE

A group incorporated in a jurisdiction must maintain a "statutory" office in that jurisdiction, and keep there a record of its stockholders to show who are the people forming the group which has the status of a corporation conferred upon it by the State. These are minimum requirements. To be sure, special agencies known as incorporating companies, of which more will be said later, make a business of providing at a low cost such facilities and service in the States most sought for incorporation. Just to give a figure, the cost may not be more than $100 a year. Still, it is an item.

ANNUAL STATEMENTS

The corporation must file at least an annual statement with the statutorily designated State officer. Though the States which bid for incorporation business do not make very burdensome requirements for these statements, still, again, they are an added item of care. For, if the corporation is substantially to do its business in New York, it will not find the labor of the public reports it must file in that State less than this labor would be if it were a corporation of that State. It may be that the advantage which would be obtained by incorporation in a certain State more than offsets the disadvantages involved in the responsibility to the added jurisdiction — as, for example, the advantage of having a no par stock at the time when only a few jurisdictions offered that privilege, and for some reason it was an important element in the plan of organization.

COSTS AT AND AFTER INCORPORATION

Questions of comparative costs may determine the State of incorporation. Here, however, we must consider not only the initial costs of incorporation, but the continuing costs after incorporation. Those States which bid for incorporations make the costs low.

For illustration, assume people proposing to organize a corporation which will actually have all its assets and do its entire business in the State of New York. They desire an authorized capital of $20,000,000. All costs here indicated are as of the moment of writing and are given simply to indicate the principle involved.

These people could incorporate in New York at a cost for organization tax of $10,000, filing fee to the Department of State of $30, and, say, $10 for filing in the county of the principal office, an aggregate of $10,040.

They could incorporate in Delaware for an organization tax of $600 and recording fee in the county where the statutory office is located by the terms of the charter of, say, $10. They could then file their statement applying for authority to do business in New York as a foreign corporation and receive certificate of authority on a fee to the State of New York of $100. So their total initial costs on incorporating in Delaware and qualifying in New York would be, say, $710 as against the initial cost of $10,040 on incorporating in New York.

Against this, however, they must consider that annually thereafter they will have to pay Delaware a franchise tax of $600, and an incorporation company, just to take a figure, $500 for maintaining a statutory office in Delaware, or an annual cost of, say, $1100, or more than eleven per cent per annum on the initial saving of $9330. Besides, they will have the additional labor of furnishing an annual report to the State of Delaware, and keeping the Delaware office informed of changes in the list of stockholders. But it would be more than eight years before the payments of annual costs offset the initial saving, and this without taking into account the discounted value of deferred payments.

Assume that the promoters want an authorized capital of $100,000. Their total initial costs of incorporating in New York would be $50 organization tax and, say, $40 filing fees, a total of $90. For incorporating in Delaware the costs would be an organization tax of $10 and recording fee of, say, $10. Against the $70 initial advantage in favor of Delaware they would have to consider a franchise tax of $10 a year and a payment for statutory office of, say, $100 a year, so that one year's charges would be substantially more than the initial saving.

TAX CONSIDERATIONS

The total problem of relative costs may not be as simple as this. It involves a careful consideration of the tax systems of all the jurisdictions which will have authority to levy any taxes on the corporation. Also it may be necessary to consider the taxation of the stockholders. If, for example, a jurisdiction did not tax the

holders of stock of corporations of the State, or of corporations having their assets in the State, and much the largest percentage of stockholders were likely to be in that State, the situation would offer one reason for incorporating there. So a survey of the entire tax situation that will be involved must be made in the process of coming to a conclusion on the place of incorporation.

CERTIFICATE OF INCORPORATION

The process of incorporation involves the preparation and filing of: (1) a certificate of incorporation; or (2) a form of application for a certificate of incorporation. In the former case the incorporation is effected on the acceptance of the certificate by the proper State officer, usually the Secretary of State, as complying with the statutory requirements, and its filing as required by the statute. The public officer does not in this case issue an instrument evidencing the authority to be a corporation. In the latter case if the proper public officer finds that the application complies with the requirements, he, under his administrative powers from the State, issues a certificate of incorporation. This process more clearly presents the appearance of a continuation of the legal doctrine that the authority for a group to do business as a corporation is a grant of special privilege from the State. The process of incorporation through the execution of a certificate by the incorporators, and its acceptance and filing, shows that the form which naturally would have been adopted if the State, on enacting its general incorporation statute, had abandoned the idea of special privilege, and adopted the idea that the certificate so executed was a contract, the filing of which was notice to the world of a restriction on the authority of the group agents, and that *contractual* liability was limited to the contributed capital. Of course this would not effect an extension of the law to a limitation of tort liability. However, the statutory development did not take this course. Though any group complying with the statute becomes a corporation, the group is nevertheless deemed to have received a grant of privilege.

DE FACTO CORPORATIONS

It cannot be assumed that acceptance of the certificate by the State officer necessarily grants corporate privileges to the group. Presumably he would not accept it if on its face it disclosed any

failure of compliance with the statute. But the statements made in the certificate may not be true, as that all the incorporators are of full age, or that two of them are citizens of the United States, or one of them a citizen of the State. If there is any failure of compliance, no corporation results. It may be, however, that the compliance is so substantial that, though strictly *de jure* no corporation results, the group will not be relegated to a partnership status, but be allowed the effects of incorporation, and be what is called a *de facto* corporation. In such a case, the State may, because of the defect, forfeit the charter, while third parties who have dealt with the group as a corporation may be estopped from taking advantage of the defect. However, it is extremely dangerous to assume that any defect is not substantial, and that the group would in fact be protected as having a *de facto* corporate status.

INCORPORATORS — THE STATUTORY GROUP

The persons executing the certificate of incorporation (or the application) are called the incorporators. They are the group. Their number may later become larger through the admission of additional members as stockholders. Though the group is numerically elastic, there is from the beginning a group. The certificate sets forth a contract among the members under which they will do business. Their contract necessarily includes the provisions of the corporation statutes regulating the relationships of the stockholders to each other and their agents, the directors and officers. In becoming a corporation they must accept these provisions. This contract or certificate is often called the charter of the corporation; strictly the "charter" includes also all constitutional and statutory provisions under which the group derives authority to do business as a corporation. In a partnership group the articles of association show the contract of the members as among themselves, their relationships to each other as distinct from their relationship to those who are not members. If a group furnishes funds to trustees who are to do business with these funds for the benefit of the members, the declaration of trust expresses the contract of the members showing their interest in the business, and otherwise their relationships to each other.

OBJECTS CLAUSES

In what are called the objects clauses of the certificate the incorporators set forth the kind of business to be done. What they include depends on the statutes of the State in which they seek the corporate privilege and may be one of the considerations entering into the choice of jurisdiction. Regularly, if they seek to do a manufacturing, mining, merchandising, or other general kind of business, they must not include also the business of banking or of a railroad or other public utility. If they want to do a banking, railroad, or other public utility business they must incorporate especially for these purposes under statutory provisions especially applying to such corporations. Though some States are more narrowly limiting as to the objects a corporation may pursue, generally, subject to the classification of banking, public utility, and other business, a group may divagate as widely as it pleases in other fields of enterprise. Whatever other limitations may exist, if the State corporate statutes permit the corporation to own the stock of other corporations, as they generally do, though sometimes limited to corporations doing a similar business, the group may achieve almost any object it wishes by the incorporation of subsidiaries.

DANGER OF WIDE POWERS

Questions might be raised of the social desirability of creating corporations capable of such acrobatic convolutions as are now possible, whereby the stockholder may find himself subjected to hazards very different from those he actually contemplated. The stockholders' control of their business through their election of the directors is hardly adequate, for a board may change the business without giving opportunity for the stockholder to express disapproval. And election of directors does not protect the the minority stockholder anyway. He may, of course, sell his stock and withdraw. To be sure, the member of the stockholder group is on notice of the terms of the certificate of incorporation and the statutory provisions under which the convolution is possible. Still, when, for example, he became a stockholder in a corporation which for many years since its beginning has confined itself to the operation of a railroad serving a certain territory, he may not in fact have contemplated finding himself turned into a stockholder in an investment company. The problem is not

simple. Narrow powers may prevent the exercise, for the stockholders' benefit, of proper business discretion.

IMPLIED POWERS

With the business purposes indicated in the certificate, the corporation has an implied power to do anything necessary or reasonably proper to carry out these purposes. It may do this even if to some extent it involves engaging in a business outside of its expressed objects. A corporation for the purpose of manufacturing requires steam or electric energy. If, for the purpose of procuring energy, a hydraulic development is reasonably desirable, and an economical development produces more than the corporation requires for its own purposes, it may, on general principles, sell the excess. It may have to consider, however, whether it will be selling it in such a manner as to be engaging in a public utility business contrary to law. But generally the disposition of incidental surpluses seems beyond question. On general principles the objects of a corporate enterprise might be sketched in with a few broad strokes, with a reliance on the doctrine of implied powers to fill in the details. However, since an express lawful provision in a charter is a comforting assurance of authority to a board of directors and their legal counsel, lawyers drafting a certificate of incorporation are likely to extend its objects clauses to some considerable length.

ULTRA VIRES

If a corporation acts outside of the powers which it has under the corporation statutes and its charter, legal terminology expresses the act as being *ultra vires*. It is impossible within the scope of a book like this to enter upon any real discussion of the effect of *ultra vires* acts. The law varies substantially with the jurisdiction. Broadly speaking there is generally a distinction among: (1) contracts which are wholly executory, that is, on which there has been no performance by either side; (2) contracts wholly executed by both sides; (3) contracts wholly executed by one side only; (4) contracts partly executed by one or both sides. If the contract is wholly executory, it may be considered the general principle that either side may refuse to perform. If the contract has been fully performed by both sides, then neither

of the parties can make its *ultra vires* character the basis of a claim against the other. If it has been wholly performed by one side, then generally the other must perform. But if partly performed by one and not wholly performed by the other, then generally neither side can demand damages for failure of further performance. In any event, the undertaking by the corporation of an *ultra vires* act lays the corporation open to an attack by the Attorney General of the State for a forfeiture of its charter.

On principle, knowledge of whether the act is *ultra vires* or not is as open to the person dealing with the corporation as it is to the members of the corporate group and their agents. The charter setting forth the corporate powers as a matter of public record is open to everyone. The person dealing with the corporation could ascertain its stated powers, and he as well as the agents of the corporation can interpret the statement. Yet it is a natural human inference that the agents of the corporation know its powers and, presumably, are acting within them, and the person dealing with the corporation, especially in matters which are small in porportion to the magnitude of the total business, is likely to act on this inference. In view of jurisdictional variations, however, these words about *ultra vires* are not to be considered at all as a statement of law, but simply as indicating the problem.

CAPITAL STOCK CLAUSES

In the capital stock clauses of the certificate or charter two sets of relationships appear. One is an aspect of the relationship of the statutory group with its creditors. If the liability of the group is to be limited to assets used or held in the association enterprise, fair dealing with the creditor demands that some assets shall continue subject to his claim and available for its satisfaction. So the general principle exists that none of the value of what the member stockholders contribute to the enterprise, as its stated capital stock, shall be paid back to them, as long as the group has creditors, or authority to contract for credit, except with the express consent of the State which created the corporation. So the certificate of incorporation provides for an authorized capital stock. It should be kept in mind, however, that this authorization simply creates a limit to the establishment of capital stock, or corporate values which must not be voluntarily diminished.

AUTHORIZED CAPITAL STOCK

This does not mean that the corporation must have the entire authorized amount as a condition of beginning business, but only that it may have this amount. Creditors are not interested in the amount of capital stock which the corporation may have, but only in what it actually does have. Presumably this limitation on the amount of capital stock which a corporation may have is a means whereby the State retains control of corporate enterprise so that it may not assume proportions which might be regarded as dangerous to the general welfare. Since nothing in the nature of capital stock limits a magnitude of assets achieved through stockholder contributions of surplus or a surplus built up from profits of the enterprise, the limitation on the capital stock is an imperfect control. Even this control is almost abandoned by the development of no par value stock corporations, which provides that whatever is paid in as capital stock shall be the capital stock of the corporation.

NUMBER OF SHARES

Capital stock provisions of the charter indicate the number of shares into which the stock shall be divided and so indicate the maximum expansion in numbers of the group. That is, if the charter says that "The authorized capital stock of the corporation shall be $2,000,000 consisting of 20,000 shares of the par value of $100 each," the group could expand to a membership of 20,000 stockholders each owning one share.

CLASSIFICATION OF SHARES

Then the charter may go on to provide for a division of the stockholder group into sub-groups. Such a division creates a relationship only among the stockholders themselves. Outside parties, as creditors of the corporation, are not interested in it. But the stock provisions may go on with a classification of shares "of which 10,000 shares shall be preferred stock and 10,000 shares shall be common stock." The provisions would continue with a statement of the "preferences, privileges, voting powers, restrictions, and qualifications" of each class of stock. Nothing in the nature of a corporation prevents the stockholders from dividing among themselves the totality of their rights and re-

sponsibilities, the elements of risk, income, and control, as they see fit. In actual practice this freedom of stockholders to contract among themselves has been utilized freely.

DURATION OF CORPORATION

What is required to be stated in the certificate of incorporation varies greatly from State to State. Each charter, and the statutes under which it is formulated, together constitute the conditions which will govern the conduct of the group's corporate affairs. So, what the charter contains depends on what the statute requires it to contain and what the statute itself contains, therefore making certain charter provisions unnecessary. One of the things which the charter generally states is the duration of the life of the corporation. It may be limited to a number of years or it may be for perpetuity. It has often been said that the State endows a corporation with perpetual life. All this really means is that when the group procures the privilege of being a corporation, the rule applicable to the group so formulated is not that which applies to a partnership, the members of which have made no express agreement as to its duration. We have seen the problem of wills involved; that when A enters a partnership with B and C he does not agree to be in partnership with B alone, much less in a partnership with B and D on a substitution of D in place of C on the death of C or by voluntary act of C. But A can, if he wishes, agree that he will do these things. When A, B, and C associate as a corporate group, by their very will to incorporate they do agree to substitution of members and admissions of new members.

CONTINUITY OF GROUP THOUGH INDIVIDUAL MEMBERS CHANGE

All that the perpetual life of a corporation means is such group continuity. If a number of people gather about a soapbox orator on a street corner, some are leaving, others coming in. At the end of a half hour no one may be there who was there at the beginning of the half hour, but there may be continuously a group of people there. And that is all there is of fact in the perpetual life of a corporation. Iteration of ideas of this kind may seem an undue stressing of the elementary. But the shorthand of

terminology of the law often confuses laymen, and not infrequently lawyers. Since that terminology is often essentially the language of analogy, as in such phrases as "corporate personality" and "corporate perpetual life," the errors in logic of reasoning by analogy creep in. Men might observe that the leg of an elephant is like a tree trunk and proceed to reason that the leg of an elephant has branches and the branches have leaves because this is so often true of tree trunks. It is unfortunate for ease and clarity of statement in our consideration of the corporation that there seems to be no single word descriptive of this kind of group. Such words as "flexible," "fluid," "mobile," though we use them, mean other things.

If the incorporators wish to stipulate that the corporate "life" shall not be "perpetual," but for a term of years, they may do so. The life of the corporation may expire by limitation or may continue indefinitely until dissolved by official action as provided by law. This may involve either forced or voluntary liquidation.

NUMBER OF DIRECTORS

The certificate provides the number of directors. The statutes require a minimum, but do not set a maximum. New York requires the names of the first board of directors to be stated in the certificate.

After counsel has drafted the certificate and the incorporators have executed it by signing and acknowledging, the next step is to file it, as required, in the public offices, where it is open to public inspection.

FILING

This seems an appropriate place to mention the services of the corporation service companies. A business has developed of providing assistance to corporations and their counsel in their formal relationships with the various governmental agencies. If counsel in New York City is taking care of the organization of a corporation which is to be incorporated in the State of New York, he can draft the certificate, attend to its execution, and mail it to the Department of State at Albany accompanied with a certified check for the organization tax and fees involved. But the Deputy Secretary of State who examines the certificate may raise some question about its provisions which may involve delay. If counsel

delivers the certificate to a service company for transmission, the company's agent in Albany can discuss the question raised by the Deputy Secretary of State and take the matter up by telephone with his New York City office, which is in touch with the attorney who presented the certificate. In this way the difficulty is likely to be overcome more quickly than it could be without the intermediary.

CORPORATION SERVICE COMPANIES

If the organizers of the corporation, though it will have its business office in New York City, wish to incorporate in Delaware, they have, in addition to the problems of transmission, the problem of having an office in Delaware to comply with the requirements of the State. For this purpose the services of the incorporation company become substantially indispensable. It maintains quarters in that State. Complying with the statutory requirement, it puts the name of the new corporation up (among many others) at the entrance to the building. The service company takes charge of the duplicate stockholder ledger. It reminds the corporation of the approach of the day on which the corporation must file an annual report, when the corporation must pay its franchise tax, and attends to the transmission of these items. These incorporating companies offer such services in each of the States commonly sought for incorporation, and presumably can provide it in almost any State.

Multitudinous names of corporations at a single doorway, including those of many of the largest enterprises in the country, supply a theme for occasional newspaper special articles, and do indeed suggest the corporations are incorporeal. But this situation does no injury to the public welfare. These corporations can be sued in the State where they maintain actual business offices. An application for a receivership must pursue the corporation to the State of incorporation. But generally no inconvenience arises from the remoteness of the jurisdiction of incorporation from the place of actual conduct of the corporate enterprise. Substantial harm does not result from the sole fact that the statutory group has its legal domicile in one jurisdiction rather than in another, but may arise from the character of the corporation statutes which are the reason for its selection of a legal residence for business purposes.

Service concerns may become literally incorporation companies by furnishing from among their employees the incorporators who execute the certificate. The name of "dummy" has become familiar to indicate incorporators or directors who are not real parties in interest. In the case of incorporators the dummy does no harm, unless our general public policy permitting such situations as agents acting for undisclosed principals is wrong. These "dummies" almost immediately disappear from the scene. The membership of a corporate group is a question of fact at any moment of time. The incorporators simply form the nucleus of a group in which the individuals may constantly change though there is continuously a group. The question of "dummy" directors will be considered more fully elsewhere.

The certificate sets forth the number of shares of stock the incorporators agree to take. Generally the aggregate is ten shares divided 3, 3, 4 among three incorporators. If the shares are of the par value of $100, this creates an aggregate liability of $1000. The service company employees acting as incorporators are usually prepared to take a chance that on the assignment of these subscriptions to real parties in interest these shares will be paid for and the liability cut off. On acceptance by the State officer and filing of the certificate in accordance with the requirements the incorporators become the corporate group.

CHAPTER IV

Organization of the Group

In order to act in business the group must organize so that it can function by the corporate processes. The fundamental regulation of its action appears in the corporation statutes under which it became a corporation, and in the certificate of incorporation drawn in accordance with those statutes. But the group can act only through its specially designated agents. And it does not meet to give instructions to its agents in ordinary matters, but through by-laws regulates their conduct in certain respects more specifically than the statutes and certificate of incorporation.

The group can change the provisions of its certificate of incorporation only by formally filing with the State an amendment adopted in accordance with the statutory provisions for amending. Though the by-laws must accord with the statutes and the charter, they are not part of the publicly filed instruments, and require no action by the public officers. The stockholders are free to make them and to change them.

By-laws are a device for stockholder control of directors and officers. A State which provides that the directors may change by-laws violates the fundamental idea. In so far as they are subject to change by directors there is no reason for their adoption by stockholders. If they are subject to such change, they are no more than resolutions of directors.

MEETING OF INCORPORATORS

After the certificate of incorporation has been filed in the required public offices, the incorporators meet. The meeting must be duly constituted. Since as yet there are no provisions for calling meetings, the incorporators must all either be personally present or have consented to the time and place. In practice the consent is signed and filed in the minutes even if all the in-

corporators are present. They are the stockholders of the corporation, and under the usual provisions have one vote for each share of stock subscribed. If an incorporator is not to be present personally, he should give his proxy to one of his fellows.

The incorporators organize by the election of a chairman and a secretary for the meeting. A letter from counsel may be presented and read stating the steps taken, taxes and fees paid, which establish the group as now a body corporate. It is ordered filed in the records of the meeting. A copy of the certificate of incorporation certified by the Secretary of State may accompany the letter. Such a certified copy is further evidence of corporate existence. Receipts for the payment of taxes and fees may be attached to it as additional proof of compliance with the statutory requirements.

BY-LAWS

Counsel has drawn up a set of by-laws out of his knowledge of probable convenience in the conduct of business and limitations which the stockholders may desire to place on freedom of action by directors. Those organizing a corporate enterprise seldom do give much consideration to the formulation of the by-laws, but rely on the experience and discretion of counsel. It would be much better for all concerned if the organizers gave more thought to them. Experienced counsel do not just copy a standard set of by-laws, but give real consideration to the particular conditions as they see them. Of course, as in other matters of draftsmanship, counsel utilize existing models.

Not much consideration is likely to be given to the by-laws in the meeting. And, indeed, that is not the place for it. The interested people should have considered them and discussed them with counsel before the meeting, for many difficult and technical problems may be involved. Minutes of the meeting are too likely to recite that each of the by-laws was read, considered, and adopted, when, as a matter of fact, nothing of the kind took place. If dummy incorporators are still acting, the failure to give real consideration to the by-laws does not matter. But the minutes of the meeting are an official record and ought to be truthful.

Location of the corporate offices, including the principal business office, if this is different from the statutory legal principal office, will be determined. Of course the stockholders do not tie

their directors to a specific street number, but to a municipal area, so that the stockholders may know where the business is. Directors will determine the definite address by resolution. Clauses fixing the date for the annual meeting of stockholders, providing for the election of directors, for special meetings of stockholders, stipulating the kind and length of notice, stating what shall constitute a quorum, and regulating the meetings, will be set forth.

One article will state the number of directors and their qualifications for office. Generally a director has a right, in absence of malfeasance, to serve through the term for which he is elected, unless the charter provides for removal, and charters do not usually so provide. But vacancies may happen through death or resignation. The by-laws provide for filling such vacancies in the board; usually that the board may itself fill vacancies happening between the annual meetings of directors. During the early months of the business this provision is likely to be utilized freely, especially for the purpose of keeping a quickly available quorum. The by-laws will cover the organization of the board, the time and place of holding its regular meetings, the holding of special meetings, and time and manner of notice.

EXECUTIVE COMMITTEE — PRINCIPLE OF DELEGATUS NON POTEST DELEGARE

If the board is to have an executive committee, an authorization of it and regulations governing it will correspondingly appear in the by-laws. The agency principle of *delegatus non potest delegare*, that an agent may not delegate his authority, crops up throughout the conduct of corporate affairs. A principal, here the group of stockholders, is willing to rely on an agent appointed by it to do the things which the agent is empowered to do, but may not be willing to rely on someone whom the agent might appoint in his place. But of course the principal may especially authorize his agent to appoint sub-agents with the same discretion in acting as the agent himself. Hence comes the authority given to a board of directors to fill vacancies and to act through an executive committee, where the by-laws so permit.

Members of the executive committee are required, to be sure, to be directors, and as such possess an authorization from the stockholders; but the authorization to directors is to act, not as

individuals, but as an entire body, presumably on deliberative consideration in formal session, where each may listen to the opinion of others, which may perhaps affect his judgment. Decisions of the board and the executive committee are by majority vote of those present and constituting a quorum, unless otherwise specified in the charter or by-laws. Here we see a distinct difference from the general agency of each partner for the partnership group. This principle pervades the conduct of corporate affairs by a board of directors.

OFFICERS

Another article in the by-laws will determine the officers of the corporation and provide for their appointment. Officers are usually chosen by the board, but in some States the treasurer or secretary is required by statute to be elected by the stockholders. Some officers, as usually the president, the treasurer, and the secretary, are statutory — the corporation must have them. Often in small corporations the offices of secretary and treasurer are combined in one person, as generally the statutes permit. In addition to these statutory offices the corporation may have such vice presidents, assistant treasurers, assistant secretaries and other officers as it desires. It is customary to give the board of directors a blanket authority to create such offices as it finds desirable. The problem of distinguishing between discretionary and administrative acts constantly arises. Almost every act calls for some degree of judgment in its performance. Care must be exercised that no power is delegated which those delegating it do not have the authority to delegate.

STOCK CERTIFICATES, ETC.

Further, an article of the by-laws will provide for the execution, issuance, and transfer of certificates of stock, and govern the matter of lost or destroyed certificates. Sections will state regulations for the declaration and payment of dividends, and will indicate the fiscal year. The form of the corporate seal will be set forth; and so on to whatever extent it is deemed desirable to have the by-laws regulate corporate affairs. Much of what the by-laws contain may be a repetition of statutory requirements, as, for example, various provisions for the annual meeting and the election of directors. Though the statute governs, it is nevertheless helpful to have these matters appear in the by-laws, where

the directors and officers of the corporation can readily refer to them.

SERIES OF AUTHORITIES

Our attention is constantly directed to the fact that throughout corporate affairs we have a series of agencies. A State constitution may contain limitations on the authority of the legislature to create corporations, or to authorize their creation. The legislature provides for incorporation under the terms of its constitutional power, and also lays down broad governing principles. Courts in their decisions are constantly defining the meaning of the statutory provisions, and indicating the principles governing the conduct of corporate affairs.

The certificate of incorporation further sets forth the conditions under which the particular group will continue as a corporation. The group limits its agency for the conduct of business to designated individuals, the directors. The idea that the group selects certain ones of its own number as its agents appears in the frequent statutory requirement that the directors must be stockholders. When the corporation statutes of the jurisdiction do not require directors to be stockholders, or authorize the incorporators to provide in their certificate that directors need not be stockholders, we see the group formation edging away from the partnership.

Formal compliance with the usual requirement that a director shall be a stockholder is so easy as to be valueless. The importance of the director-agent being selected from this group arises from the fact that he then has part of his own fortunes entrusted to the joint enterprise, which should be an influence towards care in the management. But in the law that person is a stockholder whose name appears on the corporate records as a stockholder. A director to whom one share of stock is properly issued complies with the usual statutory requirements; and perhaps in some jurisdictions he is properly qualified if immediately thereafter he assigns his certificate to another (who, intending to keep the qualification good, leaves these shares registered in the original name) so that the director no longer has even a minimum hazard in the enterprise. This is not good practice, however, and not to be relied on. The courts of at least one jurisdiction have held that it does not constitute qualification. The requirement, where it exists, that a director shall be a stockholder, is only a nuisance.

A board of directors in turn delegates, as it is authorized to do, a certain amount of authority to its officers. Statutory regulation of these officers is in part at least for the purpose of assuring the corporate responsibility to the State under which the group has its corporate existence. In the ordinary conduct of affairs the stockholders meet only at long intervals. Small corporations often neglect even to hold their statutory annual meeting, and the board of directors, as "holdovers," continue to conduct the corporate business, and to fill vacancies in the board. Such procedure may subject the charter to forfeiture or lead to other unfortunate results.

Directors meet more frequently. The usual provision for regular directors meetings is once a month. Again, in small corporations, the regular directors meetings are often not held regularly. This causes the directors to assemble only when some action is to be taken for which the statute requires action by the board, or when the officers especially feel that they want the protection of expressed authorization from the board. Ignorance and neglect of directors' responsibilities is one of the scandals of American corporate management. Yet in small corporations, in which the officers are themselves a majority of the board and are actively conducting the corporate affairs, the need for formal meetings of directors is not as great as in larger enterprises. On the other hand, there is always in fact the question of authority, and on important matters it is desirable that a formal meeting be held in order that the minutes may show and perpetuate evidence that authority did exist.

ELECTION OF DIRECTORS

In our consideration of various matters suggested by the topic of by-laws we have diverged from narration of the course of the first meeting of incorporators. After adopting the by-laws, the incorporators may next elect the board of directors, unless, indeed, as in New York, the certificate of incorporation already names them. If dummy incorporators are acting, probably they will do no more in their meeting. They execute assignments of their statutorily required stock subscriptions to persons who are really interested in the organization; and the secretary enters these assignments in the minute book.

If the organizers, the real parties in interest, contemplate the

issuance of stock for property instead of cash, the incorporators may authorize the transaction. On such authorization, presumably, the stockholder group may not thereafter question the matter as a proper or improper exercise of judgment on the part of directors as to the value of the property. The stockholder group has acted for the existing members and whoever may enter the group thereafter. But promoters may not with certain safety hide behind the action of a group of dummy incorporators and a board of dummy directors. The courts may find the real parties in interest for the benefit of creditors. And putting a dummy group through bankruptcy to clear them of liabilities does not present a pretty spectacle.

FIRST MEETING OF DIRECTORS

In the meeting of incorporators the group has designated the director-agents who have authority to enter into business transactions for the group enterprise. Since these directors are themselves a group, and are authorized to act only in association, as a board, they in turn set up a mechanism for group functioning. They must appoint the officers who will execute their decisions as a board, and to whom the board may delegate such authority as it is authorized to delegate under the limitations of the by-laws and the governing principles of law. Usually the directors hold their organization meeting immediately after the meeting of incorporators.

Ordinarily corporate by-laws authorize not only the president, but also a stated number of directors, to call a meeting of the board. Though the corporation as yet has no president, the machinery exists for calling a board meeting. It is seldom utilized for the first meeting, but, as in the case of the incorporators, the new directors all sign a waiver of notice of time and place, and consent that the meeting be held as indicated. In general the appearance of a director at a meeting, without objecting that it is not validly constituted, would amount to a waiver by him of a proper call; still, even though he is present, it is desirable to have him sign the waiver and consent. Evidence of his mere presence would rest on the secretary's entry in the minutes, the correctness of which he might dispute, or he might declare that he had objected to the meeting, and that the secretary had failed to note his objection. The record should evidence in the best

practicable manner the valid constitution of corporate meetings both of stockholders and of directors. Signing a waiver also evidences an acceptance of the office of director by the person signing. Evidence of consent to serve should be promptly taken in some manner and perpetuated in the records.

So the board proceeds to the election of officers. Directors need not vote by ballot, but signed ballots filed in the records establish evidence of an election. They must elect the statutory officers: president, secretary, treasurer; and they will elect such other officers as the by-laws permit and the directors deem desirable.

RESOLUTIONS OF FIRST MEETING OF DIRECTORS

Certain resolutions are necessary for beginning corporate transactions. One is the adoption of a seal for the corporation. The incorporators adopted a by-law which set forth the form of seal for the corporation. Counsel has had a die prepared for impressing the corporate seal, and the board adopts this impression as the seal of the corporation. The corporate seal is a pivot on which one argument for corporate personality turns. Only persons have seals; therefore the corporation, having a seal, is a person. The syllogism has the weakness of syllogistic argument, the possibility that the premises may not be true. It is sufficient for our purpose to know that the corporate group requires a seal to authenticate instruments as being corporate acts and, when the purpose is so indicated, to create a sealed instrument of the corporation.

If the stock certificate forms have been engraved or printed, specimens will be presented and a resolution passed adopting them as the form or forms of stock certificates of the corporation.

Business next on the agenda may be provision for opening a bank account or accounts. Each bank has its own requirements of the form of resolutions for corporate accounts, and the form required by each bank in which the directors contemplate the immediate opening of an account will have been obtained and will be followed in the resolutions adopted. The bank, fully aware that all corporate action is necessarily by an agency, must know that the agents have authority to order payment of corporate funds, in short, to draw checks. To this end the bank will require, in addition to the resolutions of the directors, a properly authenticated copy of all governing by-laws.

Usually by-laws provide for the signatures of two officers to draw corporate funds. The purpose of this as a safeguard for the proper application of these funds is obvious. No amount of paper work, however, can prevent bad business practice. Too often, especially in small corporations, on the requirement of two signatures, one of the signing officers signs checks in blank which the other signing officer can use as occasion requires. If one of the signing officers is likely not to be present at any time when his signature may be required, it is well to have additional officers authorized to sign. All such signing officers ought to be fully cognizant of their responsibilities, and really understand that the check is a proper application of money before signing. Only experience and a fundamental sense of integrity, a constant consciousness of responsibility, can qualify a man for business, even in such elementary matters as these.

AUTHORIZING ISSUANCE OF STOCK

It may be that the corporation has been organized for the purpose of directly acquiring an existing business, or assets other than money. That is, the owners of the existing business, instead of requiring payment in cash, have agreed with the promoters of the corporate enterprise to sell the business for stock in the corporation. We will not delay here to discuss the responsibilities of promoters; but, assuming that they are fulfilled, we are considering only the matter of stock issuance. We will not discuss here, either, the form in which the proposal appears, whether as a contract, between the owners of the assets and the promoters of the enterprise, of which the corporation is taking an assignment, or whether the owners of the assets are making an offer directly to the corporation. In either case probably the incorporators will already have authorized an acceptance of the offer which the directors now have before them.

Even if the tangible assets which the corporation will use are obtained in this way, presumably the enterprise will require more cash than would be received on the payment of the incorporators' subscriptions of ten shares. The directors authorize the taking of subscriptions for stock, and state the conditions of payment and issuance. We defer general consideration of capital stock for later discussion. But here we note the general principle that existing stockholders have a right to subscribe pro rata to the

number of shares they own for additional stock to be issued for cash. This right, generally existing, may be cut off, under some statutes at least, by provisions in the certificate of incorporation. Assuming that the right exists, it is necessary to give the stockholders, who, in our case, so far, are only the incorporators, an opportunity to subscribe for their pro rata of the additional stock to be presently subscribed. Generally it is more convenient to have them execute waivers of their rights, and to enter the waivers in the record, instead of offering the stock to them, and establishing a record of the offer and the extent of acceptance. Though in the case of stock to be issued for property the general principle seems to be that it need not be offered to existing stockholders, it is good practice to procure waivers from them if the enterprise is still at the initial stage.

Those who carry on corporate business, we may note by way of review, must be able to trace the following line of authority for every act:

State constitution
Statutory enactment
Certificate of incorporation
By-law (or special stockholder resolution)
Resolution of board of directors

So the conduct of corporate enterprise conforms to the idea that the group owner enjoys the benefit of conducting its affairs on terms not known to the Common Law, as if on notice to the world by which all are bound without privity of contract, and as a grant of special privilege from the sovereign State. And this is so, though as a matter of statutory law all men may engage in business in this way, and what all men have a right to do is not a privilege. So we have a paradox. About the only vestige of the idea of privilege actually remaining appears in special taxation of the corporate form. The corporation is still a crude instrument. On continued use it will be developed into a safer and more efficient social device.

CHAPTER V

Conducting the Group Business

We may now consider the business group as formed, and organized for the conduct of business. The mechanism has been set up for effecting a resolution of the wills of the individual members, enabling action to be taken. Obviously a large part of the solution of the conflict of wills is that stockholders do not concern themselves with decisions on day to day policy, but leave them to the small group of the board of directors; they in turn largely solve the problem of conflict of wills by leaving decisions on all ordinary transactions to the officers they appoint. Expressed in a phrase, stockholders control, but do not manage; directors and officers manage.

Not considering at this point any particular transaction, or matters of policy, we will go on to the general process of the group functioning. We are first concerned with the manner in which the stockholders exercise control. They have their regular stated annual meeting for the election of directors, and may have special meetings as occasion arises. The statutes lay down general rules for calling and holding stockholders meetings, and, as we have seen, the by-laws supply specific provisions within the lines which the statutes indicate.

PLACE OF STOCKHOLDERS MEETINGS

Some statutes require that stockholders meetings be held in the State of incorporation. Other statutes permit these meetings outside of the State, if the certificate of incorporation, or the by-laws, as the case may be, under the statute, so provide. Permission to hold stockholders meetings outside of the State may be one of the considerations entering into the selection of the State of incorporation. The picture of counsel and secretary of the corporation, with a satchelful of proxies, taking the train to hold a meeting of stockholders in the State of incorporation is

familiar in American corporate enterprise. Whatever the place may be, however, presumably the by-laws indicate it, and the time for the annual meeting.

CALL OF THE MEETING

Since the annual meeting is assumed to be held as a matter of course, on principle, the notice may be sent by the proper officer of the corporation without any action by the board of directors. For special meetings, on principle, the board of directors would call the meeting, and the secretary send out notice, in which case the notice would read that it is pursuant to resolution of the directors. Whatever the process, it must carefully comply with statutory and by-law requirements in order that the meeting may be validly constituted. For example, if the statute (or by-laws) requires that notice be given not less than ten nor more than forty days before the time set for the meeting, the notice must be given within the period indicated. Under the usual provisions, notice may be given either by serving it personally on the stockholder or by mailing it to him at the address which he has given for the corporate records. Of course, personal service would seldom be made. The secretary has a duty to see that proper record is made in the minute book to show due service of notice, and so provide evidence that in this respect the meeting is validly constituted. Entry of a complete affidavit of mailing is a desirable procedure.

Notice is properly given if mailed to all stockholders of record. In order to afford opportunity for making up the list, the stock ledger may be closed against transfer for a few days before the mailing. The technique of transferring stock, however, has developed to such a point that even corporations whose stock is actively dealt in do not find it necessary to close the books, or close them for more than a brief time. The records are complete and available for mailing at the end of each day. It is fundamental that only those persons whose names are actually entered on the stock records have fully completed their right to recognition as stockholders. Though a person who has bought the shares of a stockholder and had the certificate endorsed in blank delivered to him may be entitled to a proxy from the seller, the corporation is protected in recognizing as members of the stockholder group only those whose names appear as such.

Stockholders may appear and vote by proxy. That is, it is lawful for them to appoint another member of the group their agent to represent them in the meeting. Such appointment, however, is a mere agency, and revocable. A proxy to one who has an "interest," as to a vendee of shares not yet transferred on the record, would be irrevocable.

Statutes or by-laws indicate the number of shares which must be represented in order to constitute a quorum necessary to have a meeting valid for the transaction of business. Proper call, notice, and the presence of a quorum constitute the meeting.

VOTING: CUMULATIVE VOTING

In some manner provided by statute or the by-laws, inspectors of election are appointed. It is their duty to scrutinize the proxies and generally to ascertain that only those entitled to vote do so, and that the number of shares voted by each stockholder is in accordance with the corporate record of his holdings.

Each stockholder has a number of votes equal to the number of shares held by him. Some statutes, however, permit the certificate of incorporation to contain a provision for cumulative voting for directors. That is, the stockholder, instead of casting a number of votes equal to his number of shares for each director, may cast his total number of votes, which is the number of his shares multiplied by the number of directors, for any one or more directors. This is a device for giving minority stockholders representation on the board. By the more usual non-cumulative voting, holders of a majority of the stock are able to elect the entire board; voting cumulatively, holders of a minority of the stock may be able to elect one or more members.

TRANSACTION OF BUSINESS

So the meeting proceeds to the election of directors and the transaction of its affairs. Generally any business of the corporation may come up at the regular annual meeting, which is on notice indicating that the meeting will be held for the election of directors and such other business as may properly come before the stockholders. Statutory requirements may, however, require that special notice, even on the annual meeting, shall be given of a proposal of certain kinds of action, as of an amendment to the

certificate of incorporation to increase the authorized capital stock of the corporation, or other amendments, or a proposed resolution to sell or mortgage all or substantially all of the assets, etc. If the business to be brought up is at all extraordinary, it is well to include specific mention of it in the notice of the annual meeting. Fair dealing with the entire body of stockholders requires that, if matters affecting their interest in any unusual way are to be dealt with, they shall have warning and the special opportunity to conduct themselves accordingly.

One of the resolutions usually moved at an annual meeting calls for a ratification of all acts of directors and officers during the preceding year. Generally this is proper. Directors and officers acting in good faith and within what they believe to be the scope of their authority are entitled to protection. Likewise those who have dealt with the officers and directors in good faith, believing they were dealing properly with the corporation, are entitled to have their transactions placed as far as possible beyond question. Sometimes there is an inadvertent stepping over the line of authorization, or a failure to perceive correctly where the line lies.

In so far as the stockholders have the power, they should give reasonable protection to their agents and sub-agents. In so far as the report of the president or chairman of the board of directors to the stockholders sets forth the specific acts done, then the ratification of the stockholders, acting on knowledge, should be effective, and the general blanket ratification may be useful. On the other hand, a body of stockholders should be alert to see that a hasty reading of important transactions should not be taken advantage of by a management to procure immunity from attack for matters which were not in the best of faith.

SPECIAL MEETINGS OF STOCKHOLDERS

Maybe, in the course of the corporate enterprise, matters come up requiring special meetings of stockholders — that is, meetings other than the regularly appointed annual meeting — to give necessary authority for proposed acts. Possibly the directors may believe that the interests of the business require an amendment of the certificate of incorporation to increase the authorized capital stock, to reduce the capital stock, to change the name of the corporation, to add to the objects clauses, to reclassify the

tion statutes permit meetings of directors to be held outside of the State of incorporation; normally the regular meetings are held at the principal business office of the corporation, though this may not be the statutory principal office. The usual period for regular meetings of directors is once a month. No call for these meetings should be necessary in order to have them properly constituted. The directors know the stated time, and that it is their duty to attend. However, in the interest of effective functioning and for the convenience of the directors, it is desirable that the secretary give the directors notice of the meeting as a reminder. At a regular meeting the board may transact any business for the corporation within the scope of its authority.

RESPONSIBILITY OF DIRECTORS

It has been said that directors have a duty to attend the meeting of the board. Unfortunately only men of experience in corporate affairs, and often not even such men, are conscious of their responsibility. In consenting to serve, a man undertakes to be diligent in the exercise of his judgment. He should know what action may properly be taken, should know that authority exists for conduct to which he gives his consent. His position as a director is sufficiently hazardous. If the line of authority is not clear to him, he should ask for the opinion of counsel to the corporation. If his judgment as to the expediency of the proposed action differs from that of his colleagues, and the matter is important, he may protect himself by asking that his vote showing his dissent be recorded, or even that his objections be entered on the record of the meeting.

Men undertake directorship in small corporations perhaps just to be "good fellows" and help some friend to make up a board for some corporate project. They seek directorships in large corporations for the prestige such positions carry. A string of them has a value corresponding to that of a large number of bathrooms and club memberships. Men seek a directorship for the immediate business advantages the connection may have to them personally; and conversely men are sought for the board for corresponding benefits outside of their possible good judgment. These itemizations are just suggestive of the multiplicity of reasons, other than adequate qualification, why men are on boards of directors.

Aside from the item of personal advantage to the director, perhaps most or all of these reasons are harmless. A man may scrupulously withdraw from a meeting of the board when a matter in which he in any way has a personal interest is to be considered. The transaction may be legally immaculate. But the fact that he is an associate of the acting members in itself exerts an influence. Though the motivating reasons for a position on a board may be harmless to the corporate interests, a man should not accept the position, or be sought for it, unless he has some experience, and consequent skill and judgment useful in the conduct of the enterprise, and unless he is aware of the duties and responsibilities of a director and will fulfil them. In spite of occasional picturesque examples of directors brought to judgment, the general supineness of American stockholders makes possible continued abuse of the office.

SPECIAL BOARD MEETINGS

If the board holds its regular stated meetings, it will not often be necessary in the normal course of business to convene in special meetings. Questions of policy require unexpected consideration, or meeting more frequently than once a month, only in times of stress, or when otherwise unusual problems arise. Special meetings may, however, become desirable, and the by-laws should provide alternative methods for calling them. Though one or more of the directors may feel that a special meeting should be held, the president may refuse to call it. Possibility of holding such meetings should not depend on the will of an officer. Two or more of the directors should have the power to convene the board, and, if a quorum assemble, have a validly constituted meeting.

Since it may become important to hold board meetings as soon as possible, calls for them are regularly provided for in the by-laws on much shorter notice than for meetings of stockholders. A requirement of five, or even three, days notice is common. Some substantial period is desirable in order that a director may have an opportunity to arrange his affairs so that he may attend; and, of course, if he lives at a distance, so that he may have time to arrive at the meeting.

Any director to whom notice has not been given may waive it. For the sake of establishing the evidence of a validly constituted

meeting, all waivers should be in writing and signed, and entered in the records. Even though the person is present and takes part in the meeting, so in fact waiving the notice, it is desirable to procure a written waiver from him. It is not ordinarily the case that notice is given to some and not to all. If it is desired to hold a meeting within a shorter time than the by-laws provide, it may be held, if all members waive notice. Except during the organization period, while the group consists only of the incorporators, or a small body of stockholders, a meeting of stockholders on waiver of notice is not ordinarily practicable; but for the small group of directors a waiver of notice may become a convenient way of constituting a meeting in shorter time than it could be done on notice.

ADJOURNED MEETINGS

The device of adjourning a duly constituted meeting to a stated time may become convenient. Though susceptible to abuse, under some circumstances it is proper enough and useful. This is especially the case during the organization period, when everyone interested is in accord as to what should be done, but various matters cannot be brought to a position to be acted upon — the concern preparing the stock certificates may not have them ready, a contract may not be drafted or executed, negotiations may still be in process. If a meeting of stockholders adjourns sine die, a new meeting will have to be constituted for further action, subject to the delay of notice and the labor of giving it, or to the labor and possible difficulty of procuring waivers. During a period of stress in corporate affairs use of the adjourned meeting may be expedient. The situation may be critical, and the directors need to meet nearly every day for a time.

RESIGNATION OF A DIRECTOR

Whether or not a director should resign may become a delicate question of conscience. Perhaps his personal affairs require such attention that he cannot conveniently give the care he should to those of the corporation. However, he accepted the position on the election of the stockholders, knowing that the anticipated term of service was until the next annual meeting; and they may reasonably expect his continuance in the office. Neverthe-

less, under the circumstances indicated, if he has no reason to believe that the affairs of the enterprise will suffer from his resignation, it would seem not improper.

The question is likely to become more difficult in a period of corporate stress. The judgment of a director as to proper policy may be at variance with that of the majority. He may believe even that they are proposing illegal action, and may foresee an involvement in an extremely disagreeable situation. Should he stay and object when his objection is clearly ineffective? Should he endeavor to have a meeting of stockholders convene? Should he even, on failing to procure a meeting of stockholders, personally communicate with them?

One of the difficulties of the corporate mechanism is that it naturally tends to develop such loyalties within the smaller group of directors as may work to the disadvantage of the larger group of stockholders. Directors know each other personally, and reluctance to give offense to associates naturally arises. A member of the board is not likely to know so well many of the numerous body of stockholders. But he should never forget that his duty is to the stockholders. On the other hand, what can he accomplish if he succeeds in convening the stockholders, or personally communicates with them?

Unless, as is rarely the case, the governing clauses of statute, certificate of incorporation, and by-laws provide for a dismissal of directors, they are entrenched, legally entitled to serve their term. The pressure of an aroused stockholder opinion might be normally persuasive, but otherwise ineffective. If he regards the action proposed by the majority as illegal, he may request that the board provide the opinion of counsel. If this opinion is given and is not adverse to legality, he may well feel that he has done all that duty requires of him.

But the board may refuse to seek opinion of counsel, or having obtained an opinion favorable to legality, he may still feel unsatisfied, and, at his own expense, seek the opinion of his personal counsel, which may be unfavorable to the action proposed by the majority. At his own hazard he may seek an injunction. But duty can seldom demand that he go so far. Besides, men are generally aware that they may be mistaken in their own judgment except in the very clearest of situations. So duty may be satisfied, and wisdom require that a director resign.

On the general principle that no man can be compelled to

render service, even though he commits a breach of contract in refusing to render it, which is not the case here, a director, by resigning, may release himself from further legal obligation to serve. If he wishes to be sure, however, that his name may no longer appear among the list of directors, to give the appearance that the conduct of the board has not been such that he felt forced to any such disavowal of its actions, he should present his resignation to take effect immediately. If his resignation is to take effect on acceptance by the board, he remains a director until such action. In case it is to take effect immediately, the board should not only cause the resignation to be entered in its minutes, but should notify the resigning director, so that his files may have the record of the receipt of his resignation. Even in their bitterest quarrels men should observe the forms of courtesy. Where the State statutes or the by-laws permit, directors may be removed by the board for malfeasance or other acts contrary to their duties. Otherwise they may insist on serving their term of office.

EXECUTIVE COMMITTEE

If the board of directors has an executive committee, its members should keep in mind that authorized action of the committee, like action of the whole board, is to be taken as a committee. It will have its own chairman, keep minutes, for which purpose the secretary of the corporation will presumably act as its secretary, and report to the board at the regular board meetings. The board should approve and ratify the acts so reported, thus completing the record of them as acts of the board done through its delegation.

CONDUCT OF DIRECTORS MEETINGS

The president of the corporation acts as chairman of the board of directors unless there is the special office of chairman of the board. Directors meetings are liable to founder on either the Scylla of mere form or the Charybdis of no formality. If the directors leave the conduct of the business entirely to the officers, the meeting becomes a form. Also, men who must function officially in groups, in actual practice hold informal conferences of two or more and come to conclusions and make decisions in anticipation of the official act. If at the official meeting they

express their reasons, listen to opposed reasons of others, and are prepared to cast their votes on the basis of all the considerations they are aware of, there is presumably no harm in these informal discussions by less than the whole board, but good, in that they lead to so much more thought on the problem and tend to save time in the formal session. But they may result in the formal session becoming the mere official carrying through of the agenda without opportunity for real group consideration.

A directors meeting, however, should not be without formality. Preparation and arrangement help conserve time. The chairman should have his agenda of matters to be taken up at the meeting, which perhaps the secretary has written from his memoranda made from time to time as business to be taken up has been called to his attention. Reading of the minutes of the preceding meeting is likely to be dispensed with — too likely. They are official records of corporate acts, and it is the duty of each director to see that they are complete and accurate. If a copy of the secretary's minutes of the preceding meeting has been sent to each director, so that he may question their accuracy at the next meeting, the reading may perhaps properly be dispensed with. If any director questions the accuracy of the minutes he has received, he should bring the matter up and have it disposed of. Business men, impatient of what in their ignorance of their responsibilities they deem a "mere formality," do not in fact listen attentively to the reading of minutes, and any human sufferer from boredom cannot be unsympathetic.

Business will be taken up in the order of the agenda: reports, if any, of executive committee, the president, the treasurer, read and disposed of; prepared resolutions presented, and so on.

Unless the chairman is competent for the purpose, and with an adequate force of personality, the meeting, through lack of sufficient formality, is likely to degenerate (from the viewpoint of its intent) into a quasi-social affair. Ability as a presiding officer at directors meetings is not the least valuable of the skills of a corporation executive, who frequently may have to sit at the head of the board. And a director who is aware of his responsibilities, with the knowledge and judgment to fulfil them, and able to express himself succinctly and adequately to the point, deserves admiration. A school for directors could perform a service useful for the proper functioning of corporate enterprise.

CHANGES IN THE CORPORATE STRUCTURE

If any change in the certificate of incorporation is desired, the corporation must resort to the special statutory provisions for that purpose. The group must go through the formal process of amending a charter, the terms of which, in one aspect, represent State control over the affairs of the corporation. This control has essentially three aspects: (1) that since the franchise to conduct business in the corporate group form is a grant of special privilege, the State may demand special taxes; (2) that since the special conditions of the corporate group form of enterprise include the idea that a creditor cannot hold the members of the group responsible beyond the amount they have specifically contributed to the purposes of the enterprise, the State must exercise some supervision to protect the creditor against this amount being diminished through any voluntary action of the group; (3) that since the contract of the members of the group among themselves, expressed in the certificate of incorporation, has as essentially one of its terms by virtue of the governing statute a provision that the other expressed terms may be changed by less than unanimous consent, the State throws the protection about the individual entering into this kind of agreement that the expressed terms may be changed only by compliance with statutory requirements.

REDUCTION OF CAPITAL STOCK

At the moment we are not concerned with (1) the special taxation of corporations. As far as we are now concerned with (2), we are dealing with the concept of capital stock, which we will consider fully later. Exigencies of the business may make desirable some return to the members of capital contributed by them; or, more frequently, when that capital has become impaired through the ill fortunes of the business, that is, without voluntary action, it may be desirable that the corporation shall not be obliged to make the impairment good before any distribution in dividends be made to the stockholders. It may be that the conditions of the enterprise are such that a reduction of capital stock can be made without injury to creditors. If there are no creditors, none will be injured, provided that thereafter the corporate statements show the reduced capital stock. Even if there are creditors, the general social advantage of some degree

of flexibility of the corporate enterprise in this respect may be sufficient to justify subjecting them to some hazard, when the probability that it will not in fact result in loss is sufficiently strong.

AGREEMENTS TO AGREE

With respect to (3), a change in the expressed terms of the contract of the members of the group among themselves through their adoption of the statutory form, which imposes general provision that the expressed terms of the contract may be changed without unanimous consent, these changes may be: in the purposes or powers of the corporation as expressed in the objects clauses of the certificate; in the number of directors which the stockholders had agreed should act for them; in the capital stock of the corporation, either increasing the authorized amount or reducing the actual paid-in capital amount; in increasing or decreasing the number of shares without changing the capital; in changing the contract among the stockholders by the division, through more than one class of shares, of the incidents of risk, income, and control in the ownership; in changing the expressed term of the continuance of the group.

To do any of these things requires an amendment of the certificate of incorporation. Statutory requirements for effecting an amendment are intended to be such as will throw a protection around those interested in the proposed change, whether they be creditors, in matters affecting the capital stock, or stockholders, in matters affecting any change in the contract of the stockholders among themselves, or the State, in any matter in which it is directly concerned.

CERTIFICATE OF AMENDMENT SIGNED BY ALL STOCKHOLDERS

If all the stockholders and subscribers to stock (including incorporators or their assignees, if the stock which they have agreed to take has not yet been issued) execute a certificate of amendment, the will of all members of the group is expressed in favor of the amendment; and generally a certificate in that form satisfies the statute as far as the protection of stockholders is concerned. Statutory requirements for the protection of creditors in the case of a proposed reduction of capital stock will be discussed in a

later consideration of that topic. It should be remembered that a reduction of capital stock is not an amendment of the certificate of incorporation, but is a special statutory procedure.

During the early stages of organizing the corporation, a certificate executed by all members of the group may be and generally is feasible. If the group consists still entirely of the incorporators, or of only a few stockholders, their signatures and acknowledgements can be obtained. And the desirability of amendment often appears in the organization process. But if the stockholder group has become at all numerous, such unanimous execution is not likely to be feasible. Besides the difficulty of procuring execution by numerous scattered individuals, the likelihood of unanimous agreement grows less as the numbers grow larger.

CERTIFICATE OF AMENDMENT ON VOTE OF REQUIRED MAJORITY

So the statutes provide for action by a stockholders meeting. It may be that for approval the statute requires the affirmative vote of two-thirds of the entire number of shares. If a two-thirds vote in a meeting is to be sufficient, question may arise why the execution of a certificate by the holders of two-thirds of the stock should not be enough. The idea of requiring a meeting, if action is to be taken on less than unanimous approval, is to give the dissenter an opportunity to express himself, and so, perhaps, win adherents to his view. It is his means of endeavor to make his will prevail in the formulation of an effective will for the group.

On affirmative action by the required majority in a stockholder meeting, the appropriate officers execute the certificate and provide required evidence of stockholder approval. Certificate and evidence are then presented to the Secretary of State (or other public officer indicated by the corporation statutes), and if they show conformance with the requirements, are filed in his office. The statute will also require filing and recording the certificate in any other public office in which the original certificate of incorporation is required to be filed and recorded.

IMPLIED AGREEMENT FOR CONTINUANCE OF ENTERPRISE

A matter for which the State makes special requirements, though not itself imposing control through its scrutiny, but which

is, nevertheless, essentially an implied part of the contract of the stockholders among themselves, relates to the actual continuance of the corporate enterprise as distinct from the continuance of the corporate group formed to conduct the enterprise. This matter, though not appearing among the expressed provisions of the certificate of incorporation, is implied from the purpose for which the members of the group formed their association.

They joined as a group with the intent of continuously conducting an enterprise, and the carrying out of that intent should not fail, or be unduly put in jeopardy, without an opportunity for the members to express their wills, which, in resolution through the corporate mechanism, should govern. After the corporation has assembled assets for the enterprise a sale of them would delay or interrupt carrying it on.

Mortgaging all the assets of an enterprise does not in itself interrupt the conduct of business. It is often done, in fact, to further the business. But the fortunes of the enterprise may result in default and foreclosure, which would deprive the corporation of the going concern assets to continue business. The creation of any debt, to be sure, might have the same result through default and levy of execution. Still the amount of debt which the directors may incur without giving a mortgage is not likely to be as great as with mortgage security, and, therefore, not as likely to jeopardize the continuance of the enterprise. It may perhaps be stated as a principle of policy that the directors ought generally to obtain stockholder authority for the creation of any indebtedness beyond that of current credits in the regular conduct of the business.

CHAPTER VI

Officers and Their Duties

President, Treasurer, and Secretary of a corporation, officers generally required by statute, have in a sense a public function as well as their duties in the conduct of the enterprise. The President in making annual and other reports to the State and otherwise executing instruments for filing in public offices, the Treasurer likewise in making such reports, or joining the President in making them, the Secretary in authenticating the execution of such reports, all have what, in some degree, are public duties to perform. Besides, the group of stockholders exists as a corporation by the force of a statute, and has from this fact something of a public aspect, and is under the protection of the statute — all of which imposes on the officers a special obligation of fidelity.

THE PRESIDENT

Usually the President is the chief executive officer of the business, empowered to conduct its ordinary daily transactions within the lines of policy which the board of directors indicate. Since this work occupies most of his time, and since we are not dealing with any particular business or kind of business, we do not have occasion to give much consideration to his duties. If the corporation does not have the office of chairman of the board, the President presides at meetings of the directors. The corporation may have one or more vice presidents authorized to perform the duties of the President in his absence, and such other special duties as may be assigned.

THE TREASURER

The Treasurer is primarily charged with the care of the funds of the business, its financial records, and the management of its

financial operations. He is responsible for the accuracy of these records and the information given from them to directors, stockholders, and the State. On his report may depend such matters as whether or not the directors may legally declare a dividend. Again, however, since most of his work deals with the daily transactions of a particular enterprise, we do not have occasion at this point to dwell on them.

THE SECRETARY

In small or medium-sized corporations the importance of the office of Secretary often is not sufficiently understood. The fact that his necessary duties do not involve judgment, and are not directly connected with making profits or losses, tends to an underestimate of their value. Their sound performance is highly important in the proper functioning of the corporate mechanism.

Affairs of the corporate form of enterprise constantly involve the question of just who has just what authority. Corporate records should give the answer adequately, clearly, and certainly. The Secretary has the job of keeping such records; and the knowledge of how to perform it, though not of vast extent, does not come from intuition.

THE SECRETARY IN THE MEETING

The Secretary attends the meetings of stockholders and directors, and takes the minutes of their transactions. He is fortunate if the presiding officer comprehends the problem of the Secretary, and in conducting the meeting brings its action to a clear focus. A well prepared memorandum, or agenda, for the meeting helps to this end. Each proposal should be clear. That it was adopted or rejected, or just how it was otherwise disposed of, should also be clear.

Unless a formal resolution prepared in advance by counsel or some other person in writing is adopted without change, in which case the Secretary will have a copy, he should be certain that he has the wording exactly. A good presiding officer will see that a proposal is in precise form before action. If he does not, the Secretary is too likely to be fearful of being a nuisance by insisting on knowing just what entry he is to make. But he has the duty of accurate record keeping.

ENTERING THE MINUTES

As promptly as possible after the meeting, the Secretary should enter the record in the minute book. It should show first that the meeting was validly constituted. If it was on waiver of notice and consent as to time and place, all the waivers and consents should be entered. If it was on call, the call signed by the proper persons should appear, and with it evidence, or an entry, showing when notice was mailed, or however otherwise given. The fact that a quorum was present should also appear. For a directors meeting, the list of names of directors attending will show the quorum. For a stockholders meeting, the fact may appear formally by a certificate of the inspectors of election or be otherwise properly established. The point is, that for corporate action there must be a meeting called on the notice required by statute or by-laws, with a quorum for the transaction of business present. One of the Secretary's duties is to have the corporate records show that this is the fact, and the wise Secretary will enter in his records as much evidence as possible to support the assertion.

After the record shows the validity of the meeting, it will go on with the entry of the transactions. Many jurisdictions require that the Secretary subscribe to and take an oath that he will faithfully perform the duties of his office, and he is not properly qualified as Secretary until he has done this. When an oath is required it should be entered in the corporate minutes. The Secretary's records of corporate acts are official, and, to be evidence, must be properly authenticated. He will sign the minutes of each meeting at the end of their entry. It is proper to have the record of the first meeting of directors show that the temporary secretary of the meeting acted until the election of the Secretary of the corporation; that the Secretary was elected; and that he took and subscribed his oath of office (where an oath is required), and thereafter acted as Secretary. In that case the minutes of the meeting should close with the statement that they are signed by the temporary Secretary to authenticate the record made by him, and by the Secretary to authenticate the record of the meeting thereafter, and both should sign.

Action taken cannot be undone. Once it is taken the Secretary's duty is to enter it on the record. Subsequent action may reverse action previously taken, but does not change the fact that previous action was taken. A Secretary may sometimes have to

resist pressure in his insistence that his record shall be accurate and complete. A corporation Secretary is not a clerk to make entries which others dictate. As Secretary of the corporation he has no superior officer, not the Treasurer, not the President, not the board of directors. He is a statutory officer, responsible for the performance of his duties. The accuracy of his records affects not only the members of the corporate group, but persons dealing with it who are not members. Were such and such officers authorized to do so and so? The answer often becomes a matter of vital importance. All who are affected have an interest in the truthfulness of the record, not only that what appears is true, but that it is also true that nothing is omitted.

It is better to have the names of mover and seconder of any proposed action appear in the record rather than just "It was duly moved and seconded." On inconsequential matters this may not be important. But if they appear in all matters, they will appear in the consequential ones. Entering them is a good habit. Their regular appearance may help make directors realize their responsibilities. If the vote is not unanimous, the Secretary may well enter the names of those voting aye and no, even though no one calls for a record of the vote. All this is for the protection of the Secretary himself, to place his record beyond successful dispute. Habit formed in times of calm may serve in good stead in times of storm. Aside from the fact that men are subject to actual forgetfulness of what they have done, that they may be mistaken about what action was taken, times of stress put pressure on generally truthful men to declare an untruth, when the truth is or seems likely to be to their great disadvantage. Disaster may be in the air, and tension at the breaking point for weeks, or even months, together.

SECRETARY'S DUTY TO CERTIFY CORPORATE ACTION

From time to time the Secretary will have to certify to corporate action. In important matters, especially in matters outside the daily routine of the business, those dealing with the corporation may require proof that those purporting to act for the corporation are acting with authority, so that the acts done by them will be corporate acts and the corporation bound thereby.

A bank, for example, will require evidence that the board of directors did in fact pass a resolution authorizing the opening of

a corporate account with it, and indicating what officers of the corporation are to have authority to draw checks, to borrow money, and to pledge assets of the corporation for security. The bank will also need to know the names of the designated officers for the time being, and what their signatures are. It will be the duty of the Secretary to certify all these matters to the bank. He will make out a certificate stating that at a duly constituted meeting of the board of directors, held at such a time and place, at which a quorum for the transaction of business was present, the board adopted a resolution as follows, and set forth the language of the resolution. He will set forth all pertinent provisions of the by-laws (and the charter) and state that they are the only such provisions. He will further certify that John Jones is the President, Henry Smith the Vice President, Richard Robinson the Treasurer, and Thomas Thompson the Secretary of the corporation (we are assuming here that these are the signing officers), and that their respective signatures follow (he will have them sign their names to the certificate here). He will further certify that he is the Secretary of the corporation, and is making the certificate for the purpose indicated — in this case to induce the bank to accept the account. He will sign the certificate as Secretary of the corporation, and affix the corporate seal to attest the instrument as his secretarial act.

In like manner he may certify to resolutions authorizing the designated officers to enter into important contracts or execute any other important corporate instruments. In matters of large importance to those dealing with the corporation it is desirable for them to have such evidence of the validity of the purported corporate act, especially if the matter in addition to being important to them is also a large transaction, or otherwise unusual, for the corporation.

EXECUTION OF CORPORATE INSTRUMENTS

The Secretary also completes the execution of formal corporate instruments by affixing the corporate seal, of which he is the official custodian, and attesting the act with his signature. The corporate seal is part of the corporate signature, just as it was the entire signature of an individual in days before the ability to write was a common accomplishment. In this phrase of "corporate signature" the idea appears of corporate personality, as

though a corporation were a person. That ready analogy is useful as a kind of linguistic shorthand, which, however, easily leads astray those who have to think about the nature of corporations and their affairs. We shall have no hesitation in freely using this usual law terminology when convenient, as it often is; but we will endeavor to keep clearly in mind the nature of the corporate group and acts done in its behalf.

Of course a corporation is not a human being, and it has no signature. Written instruments evidencing acts, as agreements entered into, or otherwise done, for the corporate group by its agents, indicate, by the particular form of signing known as the corporate signature, that the persons serving as agents are in fact acting for the group. To the informal signature as "Universal Manufacturing Corporation, by John Jones, President" used in such matters as letters, checks, ordinary promissory notes, etc., the Secretary, in the execution of more formal instruments, affixes the corporate seal to the left and beneath writes "Attest, Thomas Smith, Secretary."

In addition to being part of the formal corporation signature the corporate seal also serves, if so indicated, for the creation of instruments legally "under seal," when the law requires them, as in deeds and mortgages, or when they are desired, as in making a bond.

STOCK LEDGER

Custody of the list of stockholders, and charge of or supervision over transfers of stock, might, in the nature of things, be a function of either the Treasurer or the Secretary. They are fiscal matters in that they show who own the shares into which the stock is divided and who, therefore, are entitled to receive dividends or other distributions; or, if the stock is not full paid, who may be called upon for further payment on the capital stock. On the other hand, the stockholder list shows the corporate group, and the Secretary generally has the duty of attending to the mailing of notices of stockholders meetings.

MAKING UP THE LIST OF STOCKHOLDERS

We will assume for the purposes of consideration that the Secretary has the custody of the stock list. In that event it will be his duty to prepare the list as of the time set for making it up

under a resolution for the payment of a dividend to stockholders of record. It will show the names of the stockholders, their addresses, and the number of shares held by each for each class of stock. The Secretary will furnish it to the Treasurer to enable that officer to send out dividend checks on the date set in the resolution for payment. Correspondingly the Secretary will have to make up the list for each notice of meeting or other communication with stockholders. The precise mechanics will vary widely from the corporation with a half dozen stockholders, who never change, to that with stockholders numbering thousands and constantly changing in the course of an active market for the shares.

Obviously the keeping of the stockholders list requires the highest degree of care. The entry in the stock ledger is the official evidence of stockholding. The legal evidence of ownership is made by the entry in the ledger. Ledger list totals of the number of shares of each class held by all stockholders of that class must at all times be in balance with the total number of shares of that class issued. If the corporation has thousands of stockholders, its shares listed on several stock exchanges, and, therefore, maintains a transfer agency in the city of each exchange, the matter is one of considerable complexity. Whoever has custody of the stock list, problems of proper transfer will come to him. Is the evidence adequate that the person applying for a transfer is entitled to have it made? All the questions of lost or stolen certificates, of deceased record owners, are likely to arise. If the problem is outside of those with which the custodian of the record is familiar, he will turn the question over to counsel.

CHAPTER VII

Termination of the Corporate Group and Further Consideration of the Group Idea

It is commonly said that the life of a corporation is perpetual, and, indeed, the certificate of incorporation regularly so provides. All this means is that no date is set for the termination of the enterprise and the disassociation of the group conducting it. In this sense practically any business is intended to be perpetual. An individual merchant who opens a store sets no date at which he will bring the business to an end. His death, to be sure, will terminate his ownership, but if the enterprise is successful it will be disposed of to those who will carry it on. If the merchant retires from business he will sell the going enterprise. But every business owned by a single individual will inevitably undergo either a termination or a change in ownership by the death of the individual.

COMMON LAW IDEA THAT GROUP EXISTENCE DEPENDS ON IDENTICAL MEMBERSHIP

In a partnership business the situation is not so clear in fact, but legal theory about it has some degree of clarity. If the partnership agreement contains no provision to the contrary, the enterprise must be liquidated sufficiently at least to pay out to the legal representatives of a deceased partner the value of that partner's share in the Common Law group enterprise. But the agreement may provide that, in spite of his death, the value of his interest shall not be withdrawn. Such a stipulation, to be sure, is regularly accompanied by a time limitation, which simply postpones the liquidation to the extent of the deceased partner's share, and no attempt will be made here to discuss the effect of such a limitation.

However, in legal theory the partnership group comes to an end. Even though the articles of association provide that the surviving partners shall continue the business, that a deceased partner's share shall remain in the business for a time, and that under certain conditions additional partners shall be admitted, nevertheless, in contemplation of the law the group comes to an end, and a new group is formed with each change. The difference between a corporation and a partnership in this respect is a difference in viewpoint. The partnership view looks at the membership identity; the corporation view looks at the fact that at the particular point, i.e., of the business, there is continuously a group conducting the enterprise.

STATUTORY IDEA THAT GROUP EXISTENCE DEPENDS ON CONTINUITY OF PURPOSE

Restating, then, the idea of corporate perpetuity, it is that, if the group associating for the purpose of conducting an enterprise elects to seek the statutory corporate form, it will be considered continuously the same group even though the members change. The idea of a group becomes essentially a matter of continuity of purpose. Also, even though one person acquires all the stock of the corporation, so that there is not in fact any group at all, or conceivably all the members of the group die, the statutory authority to formulate a group continues. The one shareholder by selling his shares may create a group as numerous as the number of shares. Though all the stockholders die, as a result, say, of a single disaster, their legal representatives have the right to an entry in the record that they are stockholders, which they may either exercise or sell. Though it is not the case that the group is "perpetual," or of continuing duration, the right in someone, somewhere, either to be or to formulate a group, continues.

STATE INITIATING ACTION TO TERMINATE STATUTORY GROUP

This right, though without expressed limitation of time, may nevertheless be terminated. The State may end it for cause, as that the corporation is violating statutory requirements, or that it is purporting to act as a corporation outside of the powers

within which it is authorized to act by the statutes and its certificate. Without delaying to enter upon a consideration of the provision in the Constitution of the United States against State legislation impairing obligations of contract, the Dartmouth College and other cases holding that grants of corporate charters are contracts with the granting State, the subsequent State constitutional and statutory provisions making such grants subject to alteration or repeal, we will remark here only the present result that the State by the Attorney General may initiate quo warranto proceedings to terminate the existence of the corporate group.

We are not here, however, interested in the possibility of action initiated by the State, but in the possible desire that the members of the group may themselves wish to bring its corporate existence to an end. Its enterprise may have ceased to be profitable. It may have received an advantageous offer for the purchase of the business. For some reason the effective will of the members is that the business should be liquidated, and the corporate existence of the group ended.

CORPORATE GROUP ITSELF INITIATING PROCEEDINGS FOR ITS OWN TERMINATION

Procedure for ascertaining the effective will of the members for this purpose varies from jurisdiction to jurisdiction. As in the case of a charter amendment, generally, if all the stockholders sign a certificate, that will serve. Likewise unless this unanimous consent is obtained, as may be expedient and possible with a very small group, but otherwise not, stockholders must hold a meeting and vote. Corporation statutes often require an affirmative vote of two-thirds of the outstanding shares. Such a provision arises out of the same idea as lies back of the similar requirement for sale or mortgage of substantially all the corporate assets. The members of the group become associated for the purpose of conducting a business, and a minority are not to have their purpose defeated by the wills of a bare majority. Yet if continuance seems inexpedient to so large a majority as two-thirds, the minority will have to accept their conclusion. We have already discussed these matters, and the reason for State supervision of them, in Chapter V.

When considering the vote required for any purpose, one must ascertain from the statute the precise requirement. Is the vote a

majority or two-thirds, as the case may be, of the shares represented at a meeting at which a quorum is present, or is it the stated majority of all the outstanding shares, whether represented at the meeting or not? If the stock is of more than one class, must the majority be of each class of stock? If one or more classes of shares are non-voting under the provisions of the certificate of incorporation, do they nevertheless have a vote for some purpose? For example, New Jersey specifically requires for dissolution the consent of two-thirds in interest of all stockholders, including the owners of non-voting shares. We will give some further consideration to non-voting shares in a discussion of devices for control.

Incidentally it may be noted that the New Jersey procedure for dissolution provides that the incorporators, when no part of the capital has been paid, may surrender the corporate franchise by the filing of a certificate executed by all of them, but beyond that moment of time the State does not provide for dissolution, even on unanimous consent, without a meeting of stockholders, and requires, besides the meeting, that the consent be, not by vote alone, but in writing also. It must be reiterated throughout that, though we find general underlying principles which we can discuss, these principles operate through some specific procedure, which may vary widely from jurisdiction to jurisdiction. Such procedure, however, would require, in addition to executing and filing the certificate of dissolution, that it be advertised, so that the world may be put on notice of the cessation of the franchise to do business. Also, the notice may cause creditors to present claims, and thus facilitate the process of liquidation.

FAILURE OR END OF CORPORATE ENTERPRISE DOES NOT TERMINATE STATUTORY GROUP

No matter what may have happened to the corporate enterprise, disaster does not itself terminate the association of the group of stockholders. It continues legally capable of conducting an enterprise in the corporate form for the authorized purposes. If the corporation is hopelessly unable to satisfy the claims of creditors, continuance will be impracticable. If they, by foreclosure of a mortgage, or in bankruptcy proceedings, or otherwise, have taken all the assets, then presumably the members of the group will not desire to continue a useless association.

CASE OF LIQUIDATION BEFORE DISSOLUTION

Or, assume that the stockholders have accepted an advantageous offer for the business. Though we have not yet considered the capital stock concept, and without an understanding of that the situation cannot be clear, let us, nevertheless, be a little more specific. Let us assume that on a sale of the business, and the satisfaction of all claims, except the rights of stockholders as such, the corporation has as its only asset $1,500,000 in cash, and that the capital stock of the corporation is $1,000,000. The stockholders do not want to embark on a new enterprise, but want the cash distributed to them. To place the situation beyond question, we will assume that the assets sold had been acquired at cost of $1,000,000, so that $500,000 of the sale price represents not only surplus, but also profit. A resolution of the board of directors will be the only corporate action necessary for a distribution of $500,000 to the stockholders. But no part of the $1,000,000 cash, which represents the capital stock of the corporation, can be distributed to stockholders except on the formal proceeding of a reduction of capital stock or a dissolution of the corporation. Since it is part of our state of facts that the stockholders do not desire to embark on any new enterprise, we are not concerned with a reduction of capital stock and a partial distribution of the cash by payment out of the surplus created on the capital stock reduction. The corporate group will dissolve and the directors will distribute the capital stock.

Let us assume that, for whatever reason, the proper procedure has been followed, and a certificate of dissolution executed and filed as required. By this action the group has surrendered its franchise to be a corporation, and, therefore, to go forward with new business. It need not, however, be in the position of having had its creditors take all its assets, or of having converted all its assets into cash and satisfied all creditors claims, before it takes the step of dissolution. The requisite majority of the group can effect a dissolution at any time.

DISSOLUTION AND SUBSEQUENT LIQUIDATION

Indeed, the group may well surrender its franchise to be a corporation long before it is in a position completely to discontinue the affairs of its enterprise. By so doing it can effect one saving.

As long as it is a corporation, it must continue to pay its annual franchise tax. When it surrenders its franchise, it will no longer have this payment to make nor the labor of rendering corporate reports to the State. Even though creditors have taken all the assets, the accrual of the tax continues a liability, and the rendering of reports a responsibility, until the corporation goes through the formal process of dissolution.

Though on dissolution the group is no longer a corporation, it continues to function in the corporate form for the purpose of closing the affairs of its enterprise. It may sue and be sued in the corporate name. But the act of dissolution changes the nature of the group. The directors become trustees for the parties in interest, the creditors and stockholders, but function as if the corporation existed. Stockholders may hold meetings. The trustee-directors act as a board. They do such business as they may now transact in substantially the same manner as before.

They may complete unexecuted contracts; they may sell assets; they may do anything necessary and proper for bringing the enterprise to a conclusion, but, since new creditors have no longer the protection of an undistributable capital stock fund, the directors may not enter into new transactions unrelated to the process of closing the business. This process may continue indefinitely — the ends of some strands of it may not be reached for years. In fact the corporation after death may come to seem as immortal as it was assumed to be in life.

EXAMPLE OF LIQUIDATION

If a corporation is insolvent, creditors may essentially take the affairs of the enterprise out of the hands of the group, leaving little for it to accomplish in the process of liquidation. For illustration, let us assume a situation in which the corporation has mortgaged its tangible assets to secure a debt of $1,000,000. It has, however, intangible assets, none of them pledged under the mortgage, aggregating a liquidable value sufficient, after paying their share of the expenses of the administration of the corporate estate, to realize $250,000. The corporation also has $500,000 of creditor claims not secured by the mortgage.

Suppose that the creditors, through proceedings in bankruptcy or through an equity receivership, take possession of the assets. Assume further that in due course the mortgage creditors fore-

close, that under foreclosure the mortgaged assets realize $500,000 after their share of administration expenses, and consequently that in the foreclosure the mortgage creditors obtain a deficiency judgment of $500,000 representing their unsatisfied claim. The deficiency judgment and the unsecured claims aggregate $1,000,000, with only $250,000 available towards their satisfaction. This will be paid out in the bankruptcy or equity proceeding. From the moment the representatives of the creditors took possession of the corporate assets, the corporation became a mere shell of an organization with nothing left to be done by the stockholder group except dissolve.

FURTHER ILLUSTRATION OF LIQUIDATION

Assume, for another example, that the corporation is not insolvent, but that its enterprise has ceased to be profitable, and the stockholders have decided to discontinue it in order to avoid further losses. To be more specific, it is a merchandising enterprise; it has a lease on a store, with a year and a half still to run, at an annual rental of $100,000. It has a stock of goods, accounts receivable of $1,000,000, and $250,000 in cash. It owes $500,000 of bills and accounts payable. The corporation carries through the procedure necessary for dissolution, and files a certificate thereof. The directors, now become trustees, still have a substantial business job on their hands.

Let us assume that within three months they sell the stock of goods for $500,000. This leaves them with a vacant store under a lease, which is both an asset and a liability. They dispose of their unexpired term of a year and three months by sub-leasing the space for a total rental for the period of $75,000, payable in monthly instalments of $5000. In the course of the next three months they succeed in collecting $900,000 of the accounts receivable and see that the rest of these accounts is probably for the most part uncollectable.

In view of the obvious solvency of the enterprise directors have paid the $500,000 of bills and accounts payable. They have had to pay six months rent in the sum of $50,000 and have collected $15,000 on the sub-lease. Assume that the expenses of these transactions have amounted to $75,000. They have taken in $1,415,000 to add to the $250,000 on hand, an aggregate of $1,665,000, and have disbursed $625,000, leaving a balance of $1,040,000. The enterprise still has a liability of $100,000 for rent

payable during the next year, against which it has an asset of $50,000 for rent receivable, and whatever collectable amount there may be of the uncollected $100,000 accounts receivable. If the director-trustees hold $100,000 against the rent liability, they have $940,000 available for stockholders, which they can and do pay as a liquidation dividend of $94 a share on the 10,000 shares of stock.

During the next year, the sub-tenant pays his rent in accordance with the terms of the lease, an aggregate of $50,000; the directors succeed in collecting $10,000 more of the accounts receivable, and definitely determine that the rest is bad. Further expenses of administration are $10,000. The directors have continued to pay the rent payable under the lease to the corporation, and have disbursed in this way $100,000, fully satisfying the liability. They have $50,000 in cash on hand and can pay a further and final liquidation dividend of $5 a share.

The illustration presents an extremely simple case of liquidation after dissolution. The director-trustees must first apply the assets to the satisfaction of all valid claims other than those of stockholders. If they should make any payments to stockholders, and not all the other valid claims should be satisfied, the directors would be individually liable to the unsatisfied claimants. After all valid claims other than those of stockholders have been satisfied, the director-trustees can then safely make distributions to stockholders. Such distributions are called liquidation dividends.

We have not brought into our examples any problem of contingent liabilities, nor, for that matter, of any liabilities which do not fall due within the period of the liquidation. In winding up under a voluntary dissolution such matters are troublesome, and presumably depend on voluntary adjustment. In a dissolution under special judicial proceedings, which State statutes provide, the settlement of contingent liabilities, and of debts not due by their terms, would proceed under defined principles, as they do in the judicial processes of bills in equity and of bankruptcy. Besides, in such proceedings, advertising for the presentation of claims sets a time limit running, so that directors and stockholders are exonerated from claims not presented within the stated time and proved.

Though we have presented examples of liquidation in connection with voluntary dissolution, it can hardly be too strongly emphasized that the cessation of the corporate franchise, resulting

in the dissociation of the corporate group, is a matter entirely distinct from the liquidation of the enterprise.

LEGAL ENTITY

Anyone reading at all in the law of corporations soon becomes familiar with such terms as "legal person," "fictitious person," "artificial person," "legal entity." In our summary of the idea of a corporation, an endeavor has been made at expression in terms of human beings acting in association. The fact that they form their association in a certain manner, i.e., organize as a statutory corporate group, causes the State, through the operation of the law, to give some effects to their subsequent acts different from those it would give if the group had associated in another manner. The form in which they act shows the intent with which they act, and people dealing with them, knowing the form, must take cognizance of the intent, and be bound accordingly.

Some of the special effects of group action in the corporate form are such as to give rise to the analogy of a group person distinct from the individual human beings composing the group: use of the adjectives "legal," "fictitious," "artificial," before the word "person" expresses a recognition of analogy rather than fact. A corporation is "like" a person in this, that, and the other point of resemblance.

EFFECT OF INDIVIDUAL INCORPORATING AND BEING SOLE STOCKHOLDER

Let us test whether or not the organization of a corporation creates a separate entity. Assume that A causes a corporation to be formed, of which he becomes the sole stockholder, as he may in jurisdictions which do not require the directors to be stockholders, and through the corporation he embarks on an enterprise. Since he has chosen to do business through a corporation, he must do it through the agency of a board of directors, to whom he must give a general discretion within such lines as he may lay down in the by-laws.

Presumably he may draw these lines so close that the directors may not engage in any transaction involving a value of more than $10 without getting special authority from the stockholders, i.e., from him. Presumably, however, he may not say that they must

not engage in any transaction whatever without getting specific authority from him. Moreover, in most jurisdictions the agency is irrevocable. In the Common Law the authority of an agent is revocable unless coupled with an interest. If the directors were stockholders, we might conceive their agency as coupled with an interest, but we have made the assumption that they are not stockholders; nevertheless, when elected they hold their office for a year, and A cannot remove them.

It is clear that A is doing business under conditions very different from those under which he would be doing it if he were conducting his enterprise directly instead of through a corporation. Though it is probably true that the directors will do pretty much what A wants done, they by the law are under a duty to exercise their judgment in all matters in which the by-laws allow them discretion. Under a duty to whom? To the stockholders. But A is the only stockholder, and if A should request them to act in a certain manner, they would have discharged their duty to him by acting in that manner.

But they may be under a duty to others besides A. If the corporation has creditors, the directors are also under a duty to the creditors. If an act to be done involves a danger that it may cause injury to any people, they are under a duty to those people not to cause the act to be done negligently; but so is any agent. Is the creditor situation different? As we shall see, the directors owe a duty to creditors not to do anything volitionally which will impair the capital stock fund. Still, so do the stockholders owe the same duty. The directors simply fulfil the duty of the principal. However, the obligation resting on the directors to exercise their judgment does seem to give them something of the color of fiduciaries.

We then have A as the sole stockholder, the only man with an economic stake in the business. Through his own subscription, and through the assignment to him of the subscriptions of the incorporators, we will assume that he has had issued to him the entire authorized stock of the corporation, say, one hundred shares of the par value of $50 a share, for which he has paid to the corporation $5000 in cash. So far the corporation appears as only another pocket which A has had made to hold some of his funds.

Then the corporation begins to conduct business. Let us assume that A had caused it to be formed for the purpose of acquiring and owning a garage and conducting a garage business. It ac-

quires the property for a purchase price of $10,000, of which it pays $2000 in cash and gives a purchase money mortgage for $8000. This leaves a corporate cash balance of $3000 for working capital. We will assume that the directors of the corporation are A, his wife, and his son, who is of full age, but that the wife and son are not in any way employed in the business, except as directors, and in the conduct of its affairs they somehow find their judgment always coincides with that of A, who gives his time to the daily conduct of its affairs.

Presently the corporation accumulates current liabilities of $5000, and has an inventory which cost $2500, but cannot be sold for more than $750, and has $500 cash in bank. Among other reasons for the failure of the enterprise to prosper, the location of the garage proves not advantageous. Default is made on the mortgage, and in foreclosure the mortgagee buys it for $7000 and obtains a deficiency judgment against the corporation for $1000. In liquidation of the business the other corporate assets provide enough to pay creditors an aggregate of $1000, leaving unsatisfied claims including the deficiency judgment on the mortgage of $5000.

In law language, the corporate entity protects A against liability for this deficit. The corporation is an artificial or legal person with which the creditors dealt and they may not look beyond it to the stockholder. One might reach the same conclusion, however, without resorting to the analogy of personality, and consider that, when the creditors dealt, they knew that A was in effect offering to contract on the condition that liability be limited to the assets contributed to the corporation, and, on the acceptance of the offer, the contract was in fact made on these terms. A's proposals that the contracts be made by the corporation showed that the proposal was for such limitation of liability. The creditors got just what they contracted for.

DISREGARDING CORPORATE ENTITY TO PREVENT FRAUD

For our next illustration we will remove A from the board of directors and, though he remains the sole stockholder, have as the directors of the corporation three employees in the garage who are mechanics, entirely unfamiliar with business and the responsibilities of their office. They rely on A, and, as directors, do whatever he tells them. Seeing that the business, in the general condi-

tion already indicated, is about to fail, A causes the corporation to purchase from himself a vacant lot next the garage, worth not more than $100, for the $500 cash on hand and notes of the corporation for $1000, whereby A became the possessor of the cash. This increases the creditor claims, including the deficiency judgment, from $6000 to $7000 and reduces the amount available to satisfy them from $1000 to $500. The obvious object of A in doing this is to secure the $500 in cash for himself, and keep it from creditors of the corporation. Presumably the creditors can have the transaction set aside. The directors were "dummies," there was no real dealing on behalf of the corporation, and A cannot take advantage of the corporate entity to have what is in fact a distribution of corporate assets made to himself when creditors cannot be satisfied.

CORPORATE ENTITY AND SUBSIDIARY CORPORATIONS: COINCIDENCE OF GROUPS

Consider another kind of situation. Usually corporations may own stock in other corporations. If one corporation owns all the stock of another corporation, have we two groups or only one group? In fact there is only one group. But that group has the legal means of creating a separate group. By sale of the stock of the subsidiary a separate group may arise. Are there two "entities"? Suppose the assets of the subsidiary become insufficient to satisfy its creditors. Can the creditors reach the assets of the holding company? The debts of the subsidiary were created really for the benefit of the holding company.

Again, however, we have essentially a contract situation. Frequently in situations of this kind the directors of the holding company are also the directors of the subsidiary. We will assume that is the case here. So we have the same agents acting for the one group in both holding company affairs and in subsidiary company matters. But, essentially, one set of creditors agreed that the group liability should be limited to assets of the subsidiary, while another set of creditors agreed that it should be limited to assets of the holding company. The offer of the directors to contract on these terms was implicit in the fact that they made their contracts with one set of creditors in the name of the subsidiary, and with another set of creditors in the name of the holding company.

We will assume that the holding company has an issue of *income*

bonds outstanding, that is, bonds in which the promise to pay interest is not absolute, but to pay if the earnings are sufficient. Any dividends which the subsidiary pays will be earnings of the holding company. What if the subsidiary has earnings legally available for the payment of dividends, but the board of directors does not declare one? Without such a dividend the earnings of the holding company are insufficient to pay interest on the income bonds. Under such circumstances the courts would not recognize separate entities. The income bondholders contracted for interest if there were earnings. The board of directors of the holding company, being also directors of the subsidiary, have the power to make earnings available. They would be committing a fraud on the income bondholders by accumulating in the subsidiary a surplus, of which the stockholders of the holding company will be the beneficiaries at the expense of the income bondholders.

OVERLAPPING GROUPS

Let us have, not one group of stockholders, but two groups, which however are not completely separate, but overlapping; that is, the two groups have only some members in common. Assume that one corporation does not own all the stock of another, but does own fifty-one per cent of it. We will assume that the holding company has income bonds as before and, without its share of earnings of the subsidiary legally available for dividends, does not have earnings sufficient to pay the income bond interest. The problem becomes more difficult.

Though the earnings of the subsidiary may be legally available for dividends, the actual payment of dividends may cripple the business of the subsidiary. That may have been the case in the next preceding example of a subsidiary with all of its stock owned by the holding company. There, however, only one group existed, and the contract of that group was not a contract to pay income bond interest when such payment would not cripple the enterprise, but to pay if there were earnings, irrespective of whether or not such payment would be injurious to the enterprise. Here, with the fifty-one per cent ownership by the holding company, we have two enterprises instead of one. The action which ought to be taken should be that which is in the best interest of the enterprise of the subsidiary, and this action ought not be frustrated because it is also in the interest of the stockholders of the holding

company and opposed to the advantage of the income bondholders.

Who is to determine whether or not the payment of a dividend by the subsidiary would be disadvantageous to its enterprise? Its board of directors is elected by the directors of the holding company who cause the majority vote of the stock of the subsidiary to be cast, and the directors of the holding company are elected by the stockholders of the holding company. The consideration of those who act on the question of dividends of the subsidiary is not free from influences other than the advantage of the subsidiary enterprise. If there is any doubt about the expediency of not declaring a dividend, the income bondholders should be able to call upon the courts to decide on the character of the action of those in control.

Strictly, though all but one share of stock of a corporation is owned by another corporation, two groups exist. And if the stockholders of one corporation own all the shares of another corporation, but do not own the shares of the two corporations in the same ratios, likewise there are two groups.

Second Section

Concept of Capital Stock

CHAPTER VIII

Concept of Capital Stock

Men engaging in an enterprise must employ things to carry on its purposes, and these things we call the assets in the enterprise. They may acquire these things with their own funds, or with borrowed money, or through some equivalence of these two ways. However the things are acquired, they are wealth used in production, and the economist calls them capital. The lawyer, the business man, and the accountant often use the word "capital" in a different way. To them it may signify the payment which men engaging in enterprise contribute to it out of their own funds, as distinguished from the funds they acquire for the business by borrowing. Of course, if men contribute tangible things instead of money, such a contribution is the equivalent of a commitment of their own funds; and if they acquire tangible things on credit, such an acquisition is the equivalent of borrowing money. Conversely, a contribution of money supplies the means of acquiring tangible things.

PARTNERSHIP CONTRIBUTION MAY BE WITHDRAWN

Let us assume the case of men associating as partners. For some kinds of business the contribution they must make out of their own funds may be very little, perhaps just the office furniture at a cost of a few hundred dollars; and they may be able to borrow many thousands of dollars for the business. Creditors lend, not on the strength of the office furniture, but because the partners personally must, out of any means they have, satisfy the claims of creditors.

Suppose A, B, and C, associating as partners, each contribute \$3000 to the partnership account, and conduct business for several months at a loss of \$1500. At that time they have cash of \$4500, and find themselves in need of funds in their personal affairs out-

side of the partnership business. They agree to pay to each of themselves $1000 out of the partnership account. Even though the partnership has creditors, the partners may make this payment to themselves. They are not obliged to continue in the business the capital contributed to it, and they have complete control to shift funds from the partnership account to their personal account without asking "by your leave" of anyone except themselves.

BEGINNING OF THE IDEA OF A FUND IN PARTNERSHIP SITUATION

To be sure, the law makes a distinction between individual funds and partnership funds under some circumstances. If one of the partners has borrowed money for his individual affairs, his personal creditor must satisfy his claim out of the partner's individual assets before he can have recourse to the partnership assets. Conversely, if the partners have borrowed money as partners, for their partnership affairs, their creditor must satisfy himself out of the assets of the partnership before he can have recourse to their assets outside of the partnership business. Except for this differentiation, however, there is no distinction between creditors of the partnership and creditors of the individual partners, or between assets of the individual partners and assets of the partnership. Yet the situation does present the idea of a fund.

The differentiation may not be without ultimate consequences. Assume that, after the partners have paid to themselves individually $3000 out of the partnership account, they all become insolvent both individually and as partners. A's personal creditors may be better off and the partnership creditors worse off by the fact of that payment to A out of the partnership account. Or if, instead of paying $3000 out of the partnership account, each of the partners had paid an additional $1000 in, then A's personal creditors may be worse off by reason of this fact. Still the partners, at least as long as their situations are solvent, are not obliged to take into account these possible consequences. The creditors, both individual and partnership, must take their chances.

Such a state of affairs is not essentially different from that of an individual in the conduct of his own business. If A pledges certain of his assets to one creditor, the creditor so secured may in the event of A's insolvency be better off than A's unsecured creditors. The secured creditor may realize one hundred per cent of

his claim, and the unsecured creditors only ten per cent of theirs. Yet as long as A is solvent he is free to create such preferences. The creditors took their chances. If he is insolvent, he may still consume his substance in riotous living until his creditors take his assets away from him. It is enough that the creditors, whatever their degree of security or lack of it, can deprive A of all his assets for their satisfaction.

NECESSITY FOR A FUND; LIABILITY, IF LIMITED, MUST BE LIMITED TO SOMETHING: REALLY NO LIABILITY IF NO FUND

But suppose A had expressly contracted with a creditor to pay only out of his account in the X bank. Presumably a creditor would not make such a contract as would leave A free to withdraw all the funds from the account without paying the debt. If he did, the creditor might remain unsatisfied, though A continued a wealthy man. Yet, if the creditor is willing to take that chance, there is no reason to prevent his doing so. In actual practice, however, if a creditor were willing to make any agreement that he was to be paid only out of a special fund, he would protect himself in some measure by some kind of stipulation that the debtor should not use the fund in a way calculated to deprive the creditor of his chances of being paid.

When men organize for business in the statutory corporate form, their selection of this form in effect reads into all their contracts a stipulation on their behalf that they shall be liable only out of the corporate fund, and, on behalf of the other party to the contract, a stipulation that the incorporated associates shall not make any payments out of this fund to themselves that will diminish it below a certain minimum, and will not make any such payment if the fund is below that minimum. A person dealing with the group knows that he is dealing on these terms, and is willing to accept them. He takes his chance that thereafter he may see members of the group living luxuriously, when he has not received back a hundred cents on the dollar of the value he furnished the group.

Moreover, the incorporated associates gain a further advantage than this, one for which they could not have contracted. If the driver of a corporation truck, while engaged in the corporate business, negligently injures a man who was not himself contributorily

negligent, the injured man cannot look for redress beyond the corporate assets to personal assets of the stockholders. And this is the case generally with tort liabilities incurred in the course of the corporate enterprise.

Here we have an almost shocking invasion of the principle that he who has the benefits ought also to sustain the burdens — *qui sentit commodum sentire debet et onus.* Stockholders sustain the burden only to the extent of their capital contribution. The social interest in having an instrumentality through which individuals may be willing to commit their funds to enterprise, which, by the conditions of large group action, they do not personally manage, changes the nature of rights. The rights and duties of those who engage in business in the corporate form differ from the rights and duties of those who do not. Nevertheless, actually, under general statutes all men may associate in this form.

JURISDICTIONS VARY: OUR PRESENTATION ESSENTIALLY A THEORY

It must be clearly understood that, in this and in subsequent chapters on the concept of capital stock, we are not endeavoring to state the law of any jurisdiction. Variations are so numerous that we cannot really generalize. We are merely presenting a theory with which various jurisdictions more or less accord, and are indicating what ought to be rather than what necessarily is. Yet it is hoped that our discussion will be helpful to an understanding of the problems involved; and, it may be, as an indication of what to look for in seeking to find how far and in just what way any actual jurisdiction has developed the concept. Statutory rights and liabilities depend on the precise phrasing of the particular statute and the way the courts of each jurisdiction interpret it. In Common Law and equity matters each State may have its peculiar developments.

As we shall see, the problem has two aspects:

(1) The fund in relation to creditors;
(2) The fund in relation to stockholders.

We will begin discussing our topic with the first aspect, that of the fund in relation to creditors, and will develop our discussion into the second aspect, that of the fund in relation to stockholders.

the shares a par value, states that they shall be of no par value. Then the general principle is that whatever the directors in fact issue the shares for shall be the fund (subject to the possibility of creating a paid-in surplus on the issuance of no par stock, which we will not here discuss). Suppose the directors call on A, B, and C to pay in only one penny for each share agreed to be taken and thereupon issue the stock. The fund is only ten cents. If the statute makes no requirement of a minimum capital stock to begin business, such a result apparently can happen. If the corporation can procure credit on that basis, the creditor must take his chance. The situation puts him on inquiry as to the facts.

STOCK

Monies paid into an enterprise, or other things transferred to it, with which the business is conducted, are the "stock" of the business; and such a stock has come to be the regular concomitant of group enterprise in the corporate form. An early form of corporation did not have a stock, but was an association for mutual protection and advantage, whose members within this protection and advantage carried on their individual enterprises of the character contemplated by the association. The incorporated stock or commodity exchange is a modern example of such an organization. We are not concerned with this kind of thing, but with the enterprise carried on by the agents of the corporate group for the benefit of the members who have contributed to the fund or stock with which the director-agents carry on the business.

CAPITAL STOCK

Since this fund is the capital of the enterprise, we have the final descriptive word of "capital stock." The ambiguous word "capital" has just been used with an awareness of its ambiguity. Are we at the moment considering capital in the economist's sense of all wealth used in the production, or are we employing the word in the accountant's sense of that part of such wealth which the enterpriser contributes out of his own wealth? For we are aware that with business conducted on credit, the creditors actually supply more or less of the wealth used in the enterprise. All this wealth, both that supplied by the enterprisers and that supplied by the creditors, is economist's wealth. It is economist's capital

in the business. Creditors as well as enterprisers supply this capital.

When the capital stock of a corporation is spoken of, the sharp accountant's distinction is being made, and the term represents wealth which the members of the corporate group have supplied for the use of that enterprise.

CORPORATE CAPITAL STOCK

Yet if we should leave the matter at this point we should be grossly misleading. So far, what has been said might be fairly descriptive of the capital contribution to individual enterprise. The complete phrase of "corporate capital stock" implies another, and highly important, limiting qualification. Corporate capital stock is that part of the capital contribution to the corporate enterprise which is in some way marked with the intent that it shall be the "fund" which shall not be volitionally diminished. If the representative shares in the enterprise have a par value, the aggregate of their par values marks the amount of value which shall be the corporate capital stock. Contributed values beyond this are not corporate capital stock, but become contributed surplus.

AUTHORIZED CAPITAL STOCK

That "the authorized capital stock shall be $50,000" does not in the least mean the corporation either shall or will have a capital stock of the stated sum or value. It means that not more than this amount may be paid in as capital stock.

STATE CONTROL THROUGH LIMITING AUTHORIZATION

Probably the limitation was intended as retaining a control by the State over the magnitude of enterprise in the corporate form. Generally the State levies the organization tax and sometimes the annual franchise tax on the basis of the authorized capital stock; such taxation is as if to say "the State grants the privilege of the corporate form of doing a business of such magnitude as can be done with a capital stock of $50,000 for the consideration of a tax (more accurately an excise) of so much. For the privilege of doing a larger business a larger tax will have to be paid." The State may conceivably be fearful that without the retention of such

control the magnitude of corporations might become of menacing proportions. That possibility, however, is not at the present time one of the problems which cause public concern over possible abuses of the corporate form. By paying the required costs, organizers can obtain the State's authority to have as large a business as their aspirations hope for, or even their imaginations conceive.

One aspect of the "authorized capital stock" has to do with the relationship of the stockholders among themselves. It is a general principle that stockholders have the right to maintain their pro rata interests in the enterprise unless they agree to the contrary, at least as far as the stock fund is created by the payment of cash. Limitation of the authority to create capital stock might be regarded as a means of keeping it within the ability of a stockholder to maintain his ratio. If the authorized capital stock is $10,000 and $5000 is presently created, of which A has a share of $1000, A knows that he cannot be forced out of his one-fifth interest by being obliged to subscribe to more than $1000 additional stock in order to maintain his ratio. But probably this thought has no influence on the charter provision.

THIS ASPECT OF STATE CONTROL IN RELATION TO PAID-IN SURPLUS

Returning to the matter of State control of the magnitude of corporate enterprise, the limitation of the authorized capital stock does not mean that the stockholders may not contribute more of economist's capital to the business than the authorized amount. The par value of the shares may be $100, but nothing prevents the stockholders, at least on the original subscription, from subscribing $300 a share. But after the original subscription, the values existing in the corporation create a practical limitation. No one will pay $150 for a share that is worth only $100.

If the authorized capital stock is $1,000,000, and on initial subscription it is all subscribed at $300 a share, the enterprise would have $3,000,000 of economist's capital, but would have only $1,000,000 of corporate capital stock, the additional going to surplus. This possibility does not mean that there is no actual element of State control of the magnitude of enterprise through the mere limitation of authorized capital stock. We shall see that if,

under the circumstances just indicated, the business should first lose $2,000,000 in value, then begin to make profits, the directors would not have to accumulate the profits in the business to make up the losses, but could begin paying the profits to stockholders. Creditors of the corporation, knowing that the capital stock is only $1,000,000 though $3,000,000 was paid in, might limit their credits accordingly. So the exigencies of business would effect a practical limitation on magnitude.

The overissue of unauthorized stock is illegal and invalid, and the corporation issuing it may be subject to an action for damages by a purchaser in good faith. And an overissuance would lay the corporation open to a quo warranto attack by the Attorney General to forfeit the charter.

SUBSCRIBING FOR STOCK

Let us assume that a certificate of incorporation provides for an authorized capital stock of $50,000, divided into 500 shares of the par value of $100 each. The incorporators executing the certificate have included in its provisions their agreement to take the shares of stock, A and B three shares each, and C four shares. The organization meeting has been held; the elected directors have chosen the officers and resolved that books be opened for subscription to the capital stock of the corporation. Those who caused the corporation to be organized, we will say R, S, T, U, and V, offer to subscribe for fifty shares each. The treasurer enters their subscriptions accordingly, and, pursuant to the resolution under which the subscription book was opened, calls upon them to pay in cash the amount subscribed. The agreements of A, B, and C in the certificate of incorporation, in effect become subscriptions on filing the certificate, and they too are called on to pay to the corporate account the amounts required for the number of shares indicated.

ISSUING STOCK

On this call of the treasurer the following amounts are paid to the corporation, presumably by check to the order of the corporation, which the treasurer endorses with the corporate name and deposits to the credit of the corporate account opened in accordance with the resolution of the board of directors:

A	pays the corporation $	300
B	" " "	300
C	" " "	400
R	" " "	5,000
S	" " "	5,000
T	" " "	5,000
U	" " "	5,000
V	" " "	5,000
		$26,000

Thereupon the names of the eight are entered in the stockholders ledger as stockholders of the corporation, and stock certificates are issued to them evidencing that they are holders of the stated number of full paid and non-assessable shares of stock of the corporation.

If A, B, and C are only dummy incorporators, not real parties in interest in the promotion of the enterprise, after the organization meeting they will assign their incorporators' subscriptions to the real parties in interest. The promotion agreement of R, S, T, U, and V, we will say, was that they should pay and have equal shares of the capital stock. So A assigns two shares of his subscription to R and one to S; B assigns one share to S and two to T; C assigns two shares to U and two to V. Then after the call for payment R, S, T, U, and V, on these assignments and on their own further subscriptions, will each pay $5200, and have fifty-two shares of stock issued to them, i.e., will have their names entered in the stock book as stockholders in this amount, which is the issuance of the stock, and have certificates for their shares executed and delivered to them.

AUTHORIZED AND UNISSUED STOCK

The authorized capital stock of the corporation is, as has been indicated, $50,000. So far $26,000 of corporate capital stock has been issued or created, and that amount is the capital stock of the corporation. But the corporation has authority to have $24,000 more capital stock, and is said to have that amount of authorized and unissued capital stock.

PART PAID STOCK

If the promoters, when planning the enterprise, had decided that they could begin the business with $13,000 in cash, and es-

timated that they would not need more cash for an indefinite period, but should be able to count on that much more, then the directors, instead of adopting a resolution that subscriptions should be paid in full at once, would pass a resolution that immediate payment of fifty per cent of the amount subscribed should be called for, and payment of the rest of the amount subscribed should be called for from time to time as they should further resolve. The capital stock of the corporation becomes $26,000 as before; i.e., that is the amount of the fund, which consists of $13,000 in cash and $13,000 to be paid on demand. If the directors do not call for payment of the amounts still to be paid, or if, on a call, the stockholders fail to pay, the liability of the stockholders is, nevertheless, an asset of the corporation. On appropriate legal action by or for unsatisfied creditors, the stockholders can be made to pay the unpaid amounts of their subscriptions.

If the subscriber to stock, who has it issued to him on part payment, sells his stock before it is full paid, he nevertheless remains liable for the balance. He is the man whose promise the corporation took, and he cannot get out of his personal liability to the corporation by a mere transfer of his rights against the corporation. If the man to whom the subscribing stockholder transfers his stock agrees, as part of the consideration paid for the stock, to pay the corporation the amount still to be paid to it, that is a perfectly good contract between the seller and the purchaser.

As to whether, when the purchaser has promised the seller to pay the corporation, it could, at that point, hold the purchaser, depends on the jurisdiction. The case presents a typical triangular situation on which jurisdictions differ. The purchaser of the stock has a contract with the seller, but no contract with the corporation on which on the strict logic of legal principles it can sue. In legal language there is no privity of contract. A statute, however, may make him liable to the corporation, if he was on notice when he bought the stock that it was not full paid. On the other hand, if the corporation cannot sue the purchaser of the stock, but sues the seller with whom it does have a contract, the seller can then sue the buyer, and, to avoid the need of two actions, some jurisdictions without statute would permit action by the corporation directly against the purchaser.

If the subscriber-stockholder, A, before making his sale had gone to the corporation and offered to procure the undertaking of B to pay, which A would assign to the corporation in considera-

tion of a release by the corporation of A's liability to it, on contractual theory such a release should be effective between the parties. But if A is one of the original incorporators, they have agreed with each other to pay; and by the terms of the subscription after incorporation the agreement of the subscribers may be with each other as well as with the corporation; in either case a release by the agents of the group, the directors, would not be sufficient on principle to release A from liability on his contract with his co-subscribers. A query arises whether, on principle, in any case, when a man enters the group by his subscription, the authority of the group agents should extend to releasing him from his liability. Problems of statutory group organization constantly confront us.

It should be remarked that the words "subscribe" and "subscription" are sometimes (as words of precision in language of the law) limited to the first, and sometimes to the first and second, of the three following different situations to which they are commonly applied: (1) to the incorporators agreeing in the certificate they execute to take stock in the corporation to be formed on filing the certificate; (2) to those subscribing on the subscriptions taken when the books are first opened for subscription; (3) to agreements with the corporation to purchase stock made after closing the books on the subscriptions taken next after incorporation. It is our purpose, however, to follow only the main thread of the idea of a corporation. Though we have by no means gone extensively into the problem of unpaid subscriptions to stock, we have touched it just to get a sense of the manner in which filaments of the thread bristle out at every point.

So far we are mentioning only agreements to pay in cash, and the authority of the directors to enforce them for the corporation. We shall have something to say later about the problem of payments in values other than cash, and of enforcement by others than directors.

CAPITAL STOCK AND NET ASSETS DISTINGUISHED — CORPORATE CAPITAL STOCK AS A MEASURE

In a sense the capital stock of a corporation is a measure, and not that with which the measure is filled. The bushel basket may contain potatoes, or turnips, or corn; it may be heaped up, or it may not be full. But distributions may be made to stockholders

only out of the overflow or that part which is above the rim of the measure. The measure, however, is not a quantity measure like the basket, but a value, of which, in turn, the unit of measure, expressed in ordinary terms, is the dollar. In our hypothetical corporation with $26,000 subscribed, the measure has become one of this magnitude of value.

For simplicity we will assume the $26,000 paid to the corporation. The directors proceeded to use the funds in the business, and at the end of a year have lost $6000 in the enterprise. The net assets, i.e., value of assets above liabilities, is $20,000, but the capital stock is unchanged; the measure of value established is not full, and certain consequences follow, i.e., that the directors may not make any distribution to stockholders. Conversely, assume that at the end of the year the directors have made profits in the business aggregating $6000, so that the value of assets above liabilities is $32,000. The measure of value is more than full, and the directors may make payments to stockholders up to an amount of $6000, bringing the values back to the amount which just fills the measure of $26,000.

REPRESENTATION TO CREDITORS

With a caution to remember that we are not using the word "representation" with all its legal significances and consequences, we may say that primarily the capital stock is a representation to creditors. Though it may also be a representation to stockholders present and future, we will confine our present consideration to the creditor aspect. The corporate group represent to those who may be asked to give credit to the corporate enterprise that it has committed values to the enterprise of the measure of $26,000. Since the group has elected the statutory corporate form of organization, a man who gives credit to it knows that the members may not withdraw funds from the enterprise unless the values remaining will not be less than the measure of $26,000.

He has no assurance from the statement of the amount of capital stock of the corporation that the values existing in the corporation at the time he deals with it equal the stated capital stock. This is not the representation, but only that the stated value was once created. If it no longer exists, the mere fact that it was once created has in itself no importance to him. The important fact to him is that no values which the corporation has, or may have, up

to the stated capital stock of $26,000, may be paid out to the stockholders, but, as far as the stockholders are concerned, all values up to $26,000 must remain available for the satisfaction of his claim.

RESPONSIBILITY FOR PAYMENT

If the statement of the capital stock of a corporation be looked at as a representation, who makes it? Is it a representation of the corporation, of the group as a whole, including the stockholders who had no part in the transaction because it was made by their agents, the directors, to whom they have given general authority to conduct the corporate affairs? To regard it so would not help an unsatisfied creditor in a claim against the corporation. He is entitled to have all the assets of the corporation applied to the satisfaction of his claim anyway, and an action for deceit against the corporation would not increase these assets.

Is it a representation of those who accept an issue of stock as full paid, when they knew that it was not, and knew, therefore, that subsequent creditors of the corporation might be misled? They do not specifically make the representation to the particular creditor. He may not have relied on it anyway. Nevertheless, whatever the basis, most American courts establish the liability of such an acceptor to the subsequent creditor for the unpaid balance.

Is the issue of the stock a representation of the directors who sanction the transaction? Or of the officers of the corporation? Presumably they have not specifically made the representation of full payment to the particular creditor. It rests on such public statements as there may be, as in the form of reports required by the State. In that event, in the absence of statutory provisions for their liability, presumably they should not be personally liable for deceit.

But frequently statutes impose a liability on them. New Jersey, for example, requires that a report signed by the president and one other officer and any two directors, stating among other things, the amount of capital stock issued and outstanding, be filed within thirty days after the first election of directors. The statute also requires that "The President and Secretary, or Treasurer, upon payment of each instalment of capital stock, and of every increase thereof, shall make a certificate, stating the amount of the capital so paid, and whether paid in cash or by the purchase of property,

stating also the total amount of capital stock, if any, previously paid and reported, which certificate shall be signed and sworn to by the President and Secretary, or Treasurer, and they shall within ten days after payment, cause the certificate to be filed in the office of the Secretary of State." And the statute further provides that "If any certificate made or any public notice given by the officers of any corporation, in pursuance of the provisions of this act, shall be false in any material representation, all the officers who shall have signed the same, knowing it to be false, shall be jointly and severally liable for all the debts of the corporation contracted while they were stockholders or officers thereof, as a penalty enforceable in the courts of this State only." This is just a sample of statutory liability imposed by some States. Since the creditor would not have to show that he saw the statement, and was in fact misled, as he would at Common Law, an action on it would not be in the nature of an action for deceit. This statutory liability is for all the unpaid corporate debts, not merely the unpaid balance of the capital stock.

LIABILITY OF ASSIGNEE OR PURCHASER

When one who has not paid the proper value for shares issued to him as full paid and non-assessable sells them, what is the situation? If the buyer knows that the representation of full payment is false, he becomes liable to the corporation or its creditors for the unpaid balance, as well as the one who sold the shares to him. But if the buyer is a purchaser for value without notice that full value had not been received by the corporation, he does not incur liability. And once the shares have gone through the special immunizing bath of purchaser for value without notice, they are washed clean of such liability whenever the purchaser thereafter, even though on notice, did not participate in the original transaction. All this, as indicated, rests on general principles. In some jurisdictions statutory provisions may result in liability of subsequent purchasers with notice.

Since we are interested at this point only in the actual creation of the corporate fund, we will not consider such remedies as cancellation by the corporation of stock issued as full paid when in fact the proper value was not given. We have next to consider the situation arising when more than the statutorily required value is contributed.

PAID-IN SURPLUS

What is the situation with respect to creditors, if the subscribers to the stock agreed to pay and actually did pay to the account of the corporation $200 in cash for each $100 par value share? The corporate assets on the issuance of 260 shares would then be $52,000, but the capital stock of the corporation would be just the same as if they had subscribed for the stock at $100 a share. The value of $26,000 in excess of the capital stock is surplus. Since the value was created by payment for shares of capital stock it is "paid-in surplus" as distinguished from an "earned surplus" arising out of profits of the business.

If at the end of a year of operation the business has made no profit, but suffered no loss, so that the corporate assets in excess of creditor liabilities are still just $52,000 in value, may the directors make any distribution to stockholders? Such a distribution up to $26,000 would not impair the capital stock. Yet in some jurisdictions, which couple the idea that dividends may be paid only out of earnings or profits with the idea that such payments may not be made when they would reduce the value of assets in excess of creditor liability below the capital stock, creditors would acquire a right beyond that conferred by the concept of capital stock. In such jurisdictions the directors could not properly declare a dividend out of the paid-in surplus.

If the corporation, however, had lost $13,000 as a result of its first year of operation, but on the transactions of the next year made profits aggregating $5000, presumably the directors, when in a jurisdiction which adds the idea of profits to that of surplus as a basis for the payment of dividends, could properly pay $5000 out to stockholders. But, as we have seen, if the business in its first year had lost $31,000, or $5000 more than its paid-in surplus, and in the transactions of the next year made $5000 of profits, the directors could not properly declare a dividend in any jurisdiction, for the lost capital stock must first be replenished.

So in some jurisdictions we have the intermediate concept of paid-in surplus, differing from capital stock in that, if impaired by losses, it need not be made good out of earnings before dividends may be paid to stockholders. In jurisdictions in which dividends may be paid whenever the value of assets in excess of creditor liabilities is greater than the amount of capital stock, the concept of a paid-in surplus loses much of its significance.

CHAPTER IX

What Effects Payment?

If stockholders have paid the corporation cash for their stock, no question arises of the amount, or the propriety of the form of payment. Money is the measure of value and the means of commanding value. In actual business practice, men do not bring coin and currency to pay for their stock. Subscribers to the stock pay by check, as in any business transaction. But prudence indicates that the corporation should not issue the stock until by certification or deposit the corporation has acquired an irrevocable bank credit satisfactory to it.

PAYMENT BY CHECK

Usual statutory provisions permit stock to be paid for by money, property, or services. "Property" is a sweepingly broad word. Suppose the corporation has issued stock, actually made out and delivered a stock certificate to a subscriber, on his delivery of a check which subsequently proves to be bad. (The subscriber promptly sold his certificate to an innocent purchaser, and disappeared beyond discovery.) Is the stock paid up, and has the corporation suffered a business loss thus early in its career, or have the officers improperly issued stock without payment? The check representing a liability of the maker is property in the hands of the payee or an endorsee, even though the maker has no funds, or insufficient funds, in the bank on which it is drawn.

Corporation statutes, to be sure, say that, if stock is issued for property or securities, the thing received must be of the value of the amount of stock issued for it. The check proved to have no value in fact. What if the check had been certified, but before payment, though promptly presented, the bank by which it was certified failed, and thereafter paid depositors only fifty cents on the dollar? Assume that the bank account was the entire fortune

of the purchaser. The "property" of the check proved not to have a value equal to the amount of stock issued for it. Yet we will assume that the directors and officers of the corporation acted in good faith in accepting the check and issuing the stock for it, and that, at least in the second case of the certified check, it could not be proved that they acted imprudently. We have come swiftly into the midst of difficulties in the problem of payment for stock.

PAYMENT WITH NOTES

What would the situation be if the promoters of the corporation agreed to take all the stock to be issued initially, and to pay for it with their promissory notes? The essential problem is the same as that of the check. Though a man who gives a check, to be sure, contemplates immediate payment, and a man who gives a note, even on demand, does not expect to pay immediately, in either case, check or note, the corporation has property which the directors may, perhaps, believe to be the value of the amount of stock issued.

Some jurisdictions permit a corporation to accept the notes of a subscriber in payment for stock, on the basis, just indicated, that the note is property. Other States refuse to allow the issuance of stock for the note of the person to whom the stock is issued. Obviously the corporation and its creditors are no better off than they would have been on an unpaid subscription. They are not so well off as they would have been if some payment had been made in cash and the stock issued as part paid and assessable.

If the corporation has an asset of undoubtable value, as cash or a tangible property, the creditor has a very different kind of assurance from that given by the hypothetical value of a claim against a stockholder on his note. Creditors may not be the only persons interested. If some stockholders have paid cash for their stock, their contribution in the enterprise is a different thing from the contribution of a stockholder who has paid his note only. Cash payment stockholders have parted from their wealth. Givers of notes have only promised to part with theirs; at the time they give their notes they may not have any wealth to part with, or, if they have it then, they may not have it when the time comes to perform their promises.

Payment by a subscriber for stock with his own note is one of

many ways in which men seek to utilize the corporate form to lift themselves by their own bootstraps, and to gain unfair advantage over their fellows. Such payment ought not be permitted. If payment is made, however, with the check or note of a person other than the subscriber, which the subscriber endorses to the corporation, the problem becomes that of "property" in general.

Though statutes do not require that property transferred to a corporation for the issuance of its stock should be of such a character as that which the corporation would necessarily acquire for the purposes of its enterprise, reasonable business practice would make such a requirement. Liquidating other people's assets is not generally part of the corporate purposes, and directors accepting assets other than those for actual use in the business might well be held to be acting *ultra vires.*

COMMISSIONS FOR THE SALE OF STOCK

Before going on with the problem of issuing stock for property, we will consider another matter. May a corporation receiving $100 in cash (or that value otherwise) issue a share of stock of the par value of $100, and out of the proceeds pay a commission to one who has induced the subscription? And if it may, what is the effect on the capital stock of the corporation? The incorporators have started the group by agreeing to take, we will assume, ten shares of stock. But the projected enterprise will require more than $1000 of contributed capital, and the incorporators are not prepared to contribute more than the amounts they have agreed in the certificate to pay. Sale by a corporation of its own stock might be regarded as one of the purposes of the group enterprise. Whatever the reasoning, it is settled that a corporation may pay out of corporate funds a *reasonable* compensation to agents who perform service in the sale of its stock.

Disregarding for a moment a definition of "reasonable," and assuming that a commission of five per cent is reasonable, what is the effect of its payment? Assume that the corporation sells for cash on these terms $1,000,000 par value of its stock and we have this result:

Cash in bank	$ 950,000
Paid for commissions	50,000
Capital stock	1,000,000

Since the corporation has not yet entered on any business other than the sale of its stock, it has no creditor liabilities. Its net assets are $950,000 and its capital stock $1,000,000. The capital stock is impaired by an expense of the business without any offsetting profit, and the impairment ought to be made up before any distribution is made to stockholders. If the stock of the par value of $100 a share had been sold for $105 a share and a commission of $5 a share paid for its sale, the capital stock would not be impaired.

Since as a result of the transaction the corporation has in fact only $95 in assets for each share of stock with which to carry on the enterprise, will the future creditors of the corporation be any better off than they would have been if the stock had been issued as full paid to a subscriber on his payment of $95 a share? Or would some stockholders who have paid to the corporation $100 a share, without any salesman to procure their subscriptions, be any better off on subsequent sales of stock at a commission of $5 a share than they would have been on the issuance to subsequent stockholders of stock for which they paid $95 a share? The answer to both questions is obviously "No." Yet this is not accepted as reason to justify the inducing of subscriptions which are to be full paid by an amount less than the par value of the stock. Possibly it may be a little easier to determine what is a fair payment to a salesman for services than what is a fair inducement to subscribe. The difference in consequences rests on an entirely legalistic distinction. In the case of the commissions, the corporation is conceived as having "received" the value, even though it is subject to a contract to pay part of that value out for something which will not thereafter be used in the enterprise.

PROBLEM OF REBATING COMMISSIONS

May a salesman rebate part of his commission of five per cent to a purchaser? He might find it possible within a certain period to sell more than twice as much stock by rebating one-half of his commissions than he could sell in that same time and keep all his commissions to himself. Yet the result would be that a stockholder to whom the agent rebated actually got his fully paid stock for $97.50. The process of his paying $100 to the corporation which paid $5 to the agent who paid $2.50 to the stockholder leaves as a net result that he is out of pocket only

$97.50 a share. Though the directors and officers of the corporation are not privy to the process, do not enter into any agreement with the agent for it, yet he is the agent for the corporation.[1] Is it not responsible for his conduct? In any event, is not the subscriber conspiring with the agent to defeat the requirement of the statute? Would not this be the case even though we make the hypothesis that $5 a share was a reasonable commission in that no other salesman would have sold the stock for less?

WHAT IS A FAIR COMMISSION?

What may determine the reasonableness or fairness of a rate of commission? Is it reasonable to pay any commission which represents the lowest price at which the service can be obtained, even though this is fifty per cent or more of the proceeds of the stock? Is it reasonable to pay a commission so large as to make it unreasonable to expect fair return to the stockholder on the sum he has paid for the stock? If all the existing stockholders have agreed that a fifty per cent commission may be paid, and every subsequent purchaser knows when he agrees to buy that this amount is being paid as a commission, the stockholders ought not complain. If the corporate statement shows the deficit so created, ought creditors complain?

At the beginning of an enterprise it is not difficult to create a situation in which all the existing stockholders agree to the commission. In the first meeting of incorporators they may authorize the directors to pay such a commission. Unfortunately, at any later stage the existing stockholders seldom know the rate of commission paid on additional issuance of stock; indeed, unfortunately, the purchasers of stock at any stage of the enterprise seldom know the amount of the commission. A person of experience in these matters may refrain from committing his funds unless he knows the commission situation. An inexperienced person may feel that to inquire is indelicate, because the salesman is entitled to pay for his labor, and the amount of his pay is his private affair. But it is not. The salesman is being paid with the purchaser's money; the purchaser should know how much he is paying for being persuaded to part with his funds.

[1] Though we are considering the salesman as an agent, his relationship to the corporation might be that of an independent contractor, which presumably would change some of the conclusions.

Fairness of commissions from the viewpoint of competitive price for the service may be determined more readily than fairness from the viewpoint of probable return on net sums received for the stock. And promoters are often in good faith unduly optimistic. It might be desirable to require all stated par stocks to be sold on such terms as would result in the net proceeds equaling the par of the stock. On such a requirement, if commissions for the sale were paid, the sale price would have to be at a premium, and might tend to cause the purchaser to inquire the reason for the premium. In England, under the Companies Act, if a commission is paid, it must be disclosed in the prospectus filed with the registrar of companies.[1]

Speaking in legal terms, the man who gets the commission is the agent of the corporate group of which the purchaser of the stock is about to become a member. The contributed new funds will belong to the group of which the contributor becomes a member. The situation is entirely different from the case of a man selling his house and paying his broker a commission. There, on completion of the sale, each of the parties goes his separate way. When the seller of the house pays the commission he is really paying his own money. It is not so with the stock case.

We are familiar with the idea that for the partnership group the members are in a fiduciary relationship to each other, and with the idea that for the corporate group this principle has been abandoned. In a corporation a stockholder may make a profit on selling his land to it for cash; and he, or one who is not a stockholder, may sell his land to it for its shares of such value that he makes a profit. This is so in spite of the fact that from the Common Law viewpoint they are in a relationship with their fellow members in which they have a common interest, and it is the duty of each to further the common, and not his individual, interest. An individual advantage is not consistent with the interest in common.

In a Common Law group there is no one except members of the group to exercise judgment of the common advantage, and each member is bound to disclose to the others all the facts in his knowledge affecting the common interest. The law gives them the right to full disclosure. On the other hand, in the statutory group the directors have a special duty of passing on transactions. They know that they must perform this duty

[1] *Corpus Juris,* Vol. 14, p. 44.

without any right to rely on stockholder or non-stockholder making disclosures, and must use diligence to see that the transactions are beneficial to the group; but they are not bound to see that the one with whom they deal does not make a profit. They must assume that he is dealing with them at arm's length, and be on their guard.

UNDERWRITING COMMISSIONS OR FEES

The directors of a corporation, desiring to assure the sale of $5,000,000 of its stock, may agree to pay investment bankers a fee of ten per cent on the par of the issue for the underwriting agreement of the bankers to take up and pay for at par all of the issue not subscribed on an offering of the stock to the present stockholders of the corporation.

If the stock is selling in the market at 98, naturally the existing stockholders do not subscribe to it at par, and the bankers must perform (as they very likely foresaw) on their agreement to take up the shares. They make a bankers' offering to their customers of the stock at 95, pay the corporation $5,000,000, take up the stock and deliver it to their customers for an aggregate of $4,750,000 (if they have been able to sell it), collect from the corporation their underwriter's fee of $500,000, and have $250,000 gross as a result of the business, against which they have had their costs of operation.

Presumably the underwriting fee of ten per cent was fixed at that rate partly because the stock was selling in the market at 98, and it was known that in fact the bankers would have to take up the entire issue and would not be able to sell it at par or might not be able to dispose of it all or at a price which would net them a profit. They might even be forced to sell at a loss or hold the stock for a better market. Yet they might make their full profit. We will assume that the directors and the bankers dealt at arm's length, and that the bargain as between them was fair. Yet here in effect is a connivance on the part of the directors essentially to issue stock as full paid for less than par. The pressure of a par stock to transactions of this kind is one of the difficulties of shares of this character. If the directors and bankers had agreed on the fee with an anticipation that the bankers would sell at par no question would arise.

It might be remarked that in the case just presented the cor-

poration has received a value different from that in the case of commissions to the salesman for the sale of stock. Though the salesman will not get a commission unless he sells stock, still he does not obligate himself to sell any, much less all. The bankers gave the corporation the value of a binding promise, which proved to be good, that the corporation would have its money. The bankers are really wholesale merchants, not commission salesmen. Still the doubt of statutory compliance is not entirely dissolved.

Legalistically, the only question arising is of the fairness of the amount of commissions or fees. The bankers buy the stock and pay the corporation par, on the condition that the fee be paid. But may the situation that the stock is not worth par be taken into consideration in determining the fairness of the fee? It has been submitted that a fee fixed with an expectation that bankers will in fact have to take up the stock and sell it for less than par runs contrary to the theory of par value stock.

FINANCE COMPANIES

Really sinister possibilities exist in another situation, that of finance companies. Promoters of a corporation may organize another corporation to market the securities of the enterprise being promoted. The promoters may be in actual control of both corporate situations, that of the company which is to operate and that of the company which is to finance. There may be members on each of the boards of directors who are not members of the other board; who may, indeed, be interested only in the company of which they are directors. Such directors presumably are endeavoring to deal for the best possible advantage of the corporation they represent.

However, if the same promoters, by whatever influence, really control the two corporations, the nominally independent directors have put themselves in a difficult position, which they had far better be out of. All commissions, fees, prices between the two companies are open to suspicion. They may be in fact fair. But the possibility that the controlling promoters have a greater interest in having the finance company make a profit than they have in an advantageous bargain for the company being financed, becomes a probability. The transactions between the two corporations do not have the presumption in fact of fairness that

arises out of transactions between parties who are really dealing at arm's length with each other.

VALUE OF PROPERTY

Coming to a difficult matter, we have to consider the problem of value in the requirement that, if stock is issued for property, the property be of a fair value equal to the par of the stock issued for it. Perhaps few ideas that men ponder upon are more elusive than those entering into the vaguely descriptive term "value." The fact that our wanderings in search of its meaning are limited to the territory of economic concepts, and, within that territory, to the field of business, gives us some boundaries; still, the area is sufficiently large to get lost in. And we get lost quite as often at least as we find our path. To change the metaphor, when juristic justice has to deal with value it has rough and ready ways. If we have a market for property, with its concomitant of a market price, it might seem that for business purposes we have a sufficiently clear path. But what is a "market" and what is a "price"?

Let us approach the problem by way of a concrete case. The directors of a corporation newly organized to engage in a manufacturing business must acquire a certain machine. They ask a manufacturer of such a machine to quote the price at which he will sell on each of several terms of payment:

(1) For cash on delivery;

(2) For thirty-, sixty-, and ninety-day notes of the corporation of equal amounts of each maturity;

(3) For twenty-year six per cent bonds of the corporation;

(4) For stock of the corporation which has a par value of $100 a share.

The manufacturer answers with the following offers to sell the machine:

(1) At $20,000 on payment by cash on delivery;

(2) At $21,000 on payment by thirty-, sixty-, and ninety-day notes of the corporation for $7000 each;

(3) At $25,000 on payment by that face amount of six per cent bonds of the corporation;

(4) At $30,000 on payment by stock of the corporation of the par value of that amount.

Probably on these offers the manufacturer is hoping that his prospective customer will find the means and have the desire to pay him in cash. In actual experience, in dealing with a corporate enterprise still in its promotion stage, he would install the machinery for the notes only on the terms of a conditional sale by which he would retain title until the notes were all paid. Ordinarily he would not make offers number 3 and 4 at all. But we are assuming that he is sufficiently hungry for business, sufficiently financed himself, and enough of a speculator to make all four offers.

Though we are directly concerned only with the matter of the issuance of stock for property, we will consider the first three offers for the light they throw on the problem of the fourth offer. Undoubtedly the directors may properly accept the first. Here is a cash price made by parties who are dealing each entirely in his own interest. Every presumption exists that the price is fair and the value may be taken as the equivalence of so much cash. As for the second and third offers, no limitation exists on the price a corporation may pay for credit. The only question arising is whether the directors act in good faith for what they believe to be the best interest of the corporation.

PAYMENT FOR CREDIT

They might properly discount or sell on the money market $21,000 in face amount of corporation notes for $20,000 in cash, if those were the best terms they could obtain, and use the cash to buy the machine. They could properly sell $25,000 in face amount of twenty-year six per cent bonds at $800 for every $1000 bond to raise $20,000 and buy the machine. Whether they sell the notes or bonds for cash to buy the machine or make the purchase directly with the paper is immaterial. In either case they acquire what may be termed two values, the value of the machine and the value of the credit.

Stated in another way, they have purchased both a machine and an assumption of a risk in the enterprise. Moreover, in a sense the credit is one of the values with which the business is carried on. In a sense, too, it is a value which under some circumstances can be sold. A man may be willing to pay $5000 cash for a house and assume a $10,000 mortgage, who would not be willing to pay $15,000 cash to provide the means of paying off

the mortgage. So a purchaser might be found for the corporate enterprise who would promise to pay more by an assumption of the debts than he would presently pay to enable the debts to be paid off. We are in one of the more nebulous parts of one of the most nebulous but nevertheless real things, going concern values.

In a liquidation, however, which preserved all the other going concern values by sale of the assets, including good will, in their entirety, but without any assumption of debts by the purchaser, the value of the credit would evaporate, as it would if the sale were of the assets piecemeal. To make the situation still more specific, assume that the corporation, whose directors are considering the purchase of the machine, has issued $35,000 of stock for $35,000 in cash, and has expended $30,000 of the cash for buildings; also has sold $25,000 of twenty-year six per cent bonds at 80, realizing $20,000, and has bought the machine for $20,000 cash.

Since the basis rate (i.e., the current interest of six per cent plus the interest equivalence of the discount) on which the bonds are sold is approximately (and for our discussion we will call it) eight per cent, the corporation and its bondholder creditors would have achieved almost the same ultimate financial result by selling the purchasers of its bonds $20,000 in face amount of eight per cent bonds at par. There is one essential difference of possible ultimate financial result from the two transactions. Bonds regularly contain an acceleration of maturity clause under which on default of interest the whole principal sum becomes due. So the discount with a mathematical interest equivalence of two per cent per annum payable semi-annually is a liability of a different kind from an actual additional current two per cent interest.

Let us set up a form of balance sheet on the discount transaction.[1]

Assets		*Liabilities*	
Cash	$ 5,000	Bonds	$25,000
Land and building	30,000	Capital stock	35,000
Machinery	20,000		$60,000
Discount on bonds	5,000		
	$60,000		

[1] It is to be understood that here and elsewhere, throughout this work, forms of accounting statements are not necessarily those which accountants would use. Accounting statements in this work are set up solely in the endeavor for clarity of the immediate discussion.

We must remember that our problem is to determine whether or not the capital stock is impaired. If we denominate discount on the bonds an asset, on the reasoning, however finespun, that it is a value of credit in the business, we have expressed the offsetting liability in presenting the full face amount of the bonds. Though actually only $20,000 was obtained by the borrowing, we show the liability at $25,000. But if the corporation defaults in the payment of interest, the acceleration of maturity clauses makes the entire $25,000 payable immediately, and our asset of "discount on bonds" disappears. It is not there for the benefit of the bondholders or any other creditor. It is a weasel asset.

Rejecting the idea that the discount on bonds may be regarded as an asset, we might express our conclusion by a restatement of the balance sheet as follows:

Assets		*Liabilities*	
Cash	$ 5,000	Bonds	$25,000
Land and buildings	30,000	Capital stock	35,000
Machinery	20,000		$60,000
Deficit (Discount on bonds)	5,000		
	$60,000		

So we show an impairment of the capital stock.

But let us return to the offer of the manufacturer to sell the machine for $25,000 in face amount of bonds. May the directors cause this balance sheet to be set up?

Assets		*Liabilities*	
Cash	$ 5,000	Bonds	$25,000
Land and buildings	30,000	Stock	35,000
Machinery	25,000		$60,000
	$60,000		

It is obvious from the fact of the offer of the machine for $20,000 in cash that the directors have essentially sold the bonds at a twenty per cent discount. If, however, they accept the offer of the machine for $21,000 in thirty-, sixty-, and ninety-day notes, probably no one would think of objecting to their valuing the machine at the face amount of the notes and issuing stock for it in that amount. Yet if they may not appropriately value it at $25,000 to offset the long term credit of the bonds, they ought not value it at $21,000 to offset the short term credit of the notes.

As a further case, assume that, after the manufacturer has taken the $25,000 face amount of bonds for his machine, the directors propose to him that he take in payment for them $25,000 in par value of stock of the corporation, and he accepts the offer. Or, assume that the bonds were issued with a provision that the holder might convert them into stock of the corporation of a par value equal to the face amount of the bonds converted, and the manufacturer presents his bonds for the conversion. (For the conversion feature the parties had better satisfy themselves that they are not likely to get into trouble in their jurisdiction.) We will further assume that the balance sheet has been set up to show the discount on the bonds as a deficit. After the exchange the balance sheet will appear:

Assets		*Liabilities*	
Cash	$ 5,000	Stock	$60,000
Land and buildings	30,000		
Machinery	20,000		
Deficit (arising from discount on bonds)	5,000		
	$60,000		

The result is that the corporation has issued stock for which it does not have an equivalence in value. To be sure, that situation often arises as a result of losses in the business. But the case here is different. Presumably losses in the business happen contrary to the will of the directors. They do not intend such losses. Here, however, the stock outstanding without an equivalence of assets in the corporation results from the voluntary act of the directors. When the directors proposed the exchange, they intentionally brought about the consequence, or when they issued such convertible bonds for the machine, they knew they were creating a situation in which it was out of their power to prevent such a deficit. We will assume that they did not issue the bonds with any understanding, contractual or by "gentleman's agreement," for the exchange, or even with an intent on their part to propose it. Still, by an exercise, not of judgment but of the will, they could have prevented the result.

Nevertheless, the exchange benefits all creditors, existing and future. For existing creditors, if there were any other than the bondholder, the amount of creditor claims is reduced and the ratio of assets to creditor liabilities increased. Such creditors

have received a benefit they had not bargained for. On our assumption that the machine was valued at its cash price, and a deficit of $5000 shown, future creditors are not adversely affected. The deficit appears, and the measure of the capital stock must be filled with value before the directors may make distributions to stockholders.

A justification that the exchange effects the payment of a debt proceeds on an incomplete factual base. Except for the effect of the acceleration of maturity clause, which we will neglect for the moment, what was really borrowed was $20,000 at an interest equivalence of eight per cent, expressed partly in terms of current interest and partly in terms of the discount. From the viewpoint of capital stock values, the directors would be justified in bargaining to exchange stock for bonds only in taking the bonds at such a discount as would place them on an eight per cent basis. And when they issued convertible bonds for the machine they would not be justified in making them convertible at par, but only on an eight per cent basis. The fact of an acceleration of maturity clause serves somewhat to diminish the error. On default the face amount would be a claim provable with the claims of other creditors. This, however, is a juristic error not in accord with the facts.

Question of the propriety of such a transaction of exchange might arise in a situation like this: promoters of an enterprise canvassing the possibilities of raising funds wish to make the most effective security appeal. The project, we will say, is for the development of a hydraulic electrical power.

Construction will require at least two years, during which the corporation will have no earnings. If the directors offer stock to "investors," or capitalists, the purchasers know that they will have to forego income from their commitment for the construction period. There will be no earnings for the directors to declare as dividends. They can, however — indeed must — pay interest on bonds. Moreover, they can charge the interest to the cost of construction, and the completed plant will become an asset at the increased "cost" with presumably a "value" properly as much as this cost. From the viewpoint of the investor, to be sure, the interest he receives may be what was his own money paid back to him. Many people, however, overlook this possibility.

The promoters conceive the idea of creating an issue of bonds

convertible into stock, not at the option of the bondholder, but at the option of the issuing corporation. Moreover, they are aware that the corporation cannot legally sell stock at a discount from par, but can so sell bonds. They propose an issue of $5,000,000 in six per cent twenty-year bonds, convertible into stock par for par at the option of the corporation, to be sold by the corporation at 80. By this process they anticipate being able at the close of the construction period to put the corporation in a sound financial position through the conversion. The investor sees that there will be an immediate return of interest, which he will call income; that presumably the bonds will not be converted until the corporation begins to make earnings and he can reasonably anticipate dividends on the stock he will receive in exchange for his bonds; that when the conversion is made he will in effect have purchased stock at 80.

Such a transaction simply repeats our antecedent problems of value in connection with the purchase of the machine with bonds, with the addition of the element of intent (though not expressed in a contract) to effect the exchange of the debt for stock. The added element of intent is important. Is this a mere device to issue stock for a value less than the par of the shares issued? If the asset to be acquired, a hydro-electric plant, may properly be valued only at the amount paid out for the purchase of the site and for construction, plus, perhaps, a rate of interest on those dollars, the transaction appears essentially a device to issue stock at less than par.

With this matter of interest as part of the cost of construction we have come into a new set of questions. Taking it for granted that a proper rate is any rate the corporation may have to pay to get the funds, how long may the construction period continue? Must construction be continuous or may it be interrupted for several years with interest added to cost? These questions are pertinent to the problem of deficits in capital stock. Society has hardly begun to formulate principles of sound practice for the determination of the amount of value in the capital stock measure.

We come at last to the offer of the manufacturer of the machine to sell it for $30,000 par amount of stock of the corporation. Would such an offer and an acceptance of it be proper? Let us inject another hypothesis, that the best terms on which the corporation could get a stock salesman to sell the stock are on a commission of 33⅓ per cent. This is a high commission, but if

stock were sold on that basis it would require the sale of $30,000 par value of stock to provide the $20,000 in cash necessary to buy the machine. Even if we regard this rate of commission too high to be allowable, some commission could unquestionably be paid with perfect propriety.

Is the fair value of the machine in payment for stock the cash price of the machine plus what it would cost to sell stock to provide that cash price? If the stock were sold for cash and the commission paid, a deficit of the amount of the commission would be established, but the transaction would be perfectly proper. But if the directors issue the stock for the machine they will have to enter the value of the machine as equal to the par of the stock, and the question remains: Is a machine which can be bought for $20,000 in cash worth $30,000 when it is paid for with stock? Have the directors fulfilled the statutory requirement for creating the fund?

It would seem that the answer ought to be that the machine should be valued in all cases at its cash price. What harm would be done, however, if the directors were permitted to sell stock for property with the same result as if the stock had been sold for cash, the commission on the sale of the stock paid, and the net proceeds used to buy the machine?

The answer is simply the formal requirement of the concept of capital stock, which does not permit a deficit to be shown on the issuance of the stock to the purchaser. The deficit created by the actual payment of commissions is more likely to represent a fair price for service than a deficit resulting from a bargain between the issuer and the purchaser is to represent a fair equivalence of what the cost of service in selling the stock would be.

Speaking now in terms of cash equivalence, if the directors deem a certain kind of property useful in the enterprise, and there is more than one selling that kind of property, presumably, if the directors make the best bargain possible to be made with any seller, they are paying a fair price, and may issue stock for that price. But there may be only one seller of the particular property desired and his price may include a great profit to him. If the directors believe that even at such a price the property would be advantageous for the corporation, presumably they may pay the price and issue stock for it. In all situations they should remember that they have a duty to perform and must be diligent.

SUMMARY

So far we have really just been stating a problem.

Though the purchase of property on credit has nothing to do directly with the problem of the capital stock fund, it has a bearing when we come to contemplate the possible liquidation of the debt by the issuance of stock.

It is submitted that, if property is bought on credit, the price may properly be only the cash price plus a fair payment for the credit, that the asset acquired may properly be entered in the accounts only at its cash price, and (assuming that the current interest, i.e., the interest regardless of discount, is at a normal rate) that any excess of the debt over the cash price represents a deficit.

Since, however, there is no essential distinction between discount and interest, except that the discount represents the sum of an annuity of an interest equivalence, then, for abnormal rates of interest, on any real analysis, that part of the interest which is abnormal ought to be translated into terms of present worth of an annuity of the excess interest, and entered as a deficit.

We have used the words "normal interest." For the purposes indicated this actually should come to economist's "true interest," or the value of capital without risk, and all premiums for risk be translated into terms of deficits.

If stock is issued in liquidation of the debt (i.e., bonds issued at 80), it ought not to be issuable in a par amount in excess of the present cash value of the asset acquired by the debt, and the balance of the debt should be liquidated in some other manner; i.e., it is absurd to issue stock merely to cancel deficits.

In the rough and ready ways that business has in many of its aspects, and in the present development of the corporate concept in the law, we do not yet get such accuracies. Yet it would be the part of prudence for those managing corporate enterprise to adhere essentially to these ideas.

However, we can say, as entirely practicable, and probably representing the actual state of the law, on real analysis, that when an asset is acquired by the direct issuance of stock, the present cash price of the asset represents the amount of the stock at par that may be issued. Directors who issue, and vendors who accept, more are taking a chance of trouble. The pain of error is more acute than that of care.

FAIR BARGAIN

Most of the cases on the overissuance of stock for property involve the fundamental question of actual bargain. Have the parties dealing really had adverse interests in determining the present fair cash price? Beyond that, the questions are: Have the directors performed their duty in bargaining for the lowest price? And in their bargaining have they performed their duty of exercising judgment as to the advantage of the corporation?

In the cases on value for the purpose of stock issuance for property, jurisdictions present a seeming variance in the principles followed in arriving at conclusions. Some follow what is called "the true value rule," and others "the good faith rule." Some jurisdictions have an express statutory provision to the effect that "in the absence of actual fraud in the transaction, the judgment of the directors as to the value of labor, property, real estate, or leases offered for stock shall be conclusive." Other statutes contain no such express exoneration. But judicial interpretation is likely to make the differing statutes and the two rules of "true value" and of "good faith" come to results not widely differing.

Honesty of intent on the part of directors in this matter, as in other matters, is not enough for "good faith." Their duty requires the exercise of judgment. They should have the capacities and skills of men competent to perform the duties they have undertaken, and use those capacities and skills in the exercise of judgment. If they have not so acted, they have not acted in a faith that is sufficiently good; if they have so acted, presumably their conclusion reaches the "actual value," or whatever the statutory requirement or rule of judicial interpretation may be. The opinion of someone else, or the fact that the property subsequently failed to demonstrate a value equal to that placed upon it, will not be sufficient to overcome the evidences of value on which they acted.

CHAPTER X

Concept of Capital Stock in Relation to Rights of Members of the Stockholder Group and to Rights of Creditors

For the purposes of our further discussion let us assume that we can establish the fact of failure of payment of value equal to the par of stock issued as full paid and non-assessable.

The transaction is either lawful or unlawful.

ONE TYPE OF JURISDICTION

Since a corporate capital stock fund is not a concept of non-statutory or Common law, and since the statutes of some States do not forbid the transaction, the courts of such States will hold it valid, and binding on all interested persons, i.e., stockholders and creditors. It may be remarked that the par of the stock can still be the measure of the value not thereafter to be voluntarily diminished; but in the case under discussion the contents do not fill the measure at the time of setting it up. These jurisdictions do not accept one of our principles, which says that the fund must be created up to the indicated measure of the par amount.

SECOND TYPE OF JURISDICTION

Just what is the agreement? The corporation undertakes to issue stock for a consideration of less than the stated par.

Seeing the agreement as expressed in these terms, courts of other States frequently find the transaction unlawful and void, because, either, as the case may be:

(1) The statute expressly or impliedly makes it so; or

(2) They find the agreement essentially fraudulent, on principles we will consider later.

THIRD TYPE OF JURISDICTION

But in some jurisdictions the courts profess to see that the bargain consists of two parts:

(1) On one side a promise to take and pay for the stock, and on the other side a promise to issue it; and

(2) An agreement that the price shall be a value less than the par of the stock.

These courts profess further to find the parts independent and separable.

It is a principle of contracts that if one part of an agreement standing alone would be valid, but another part is invalid, and the two parts can be divided, as essentially separate agreements, the valid part can be enforced, though the other cannot. However, a promise and the consideration therefor are not separable. If the consideration is unlawful, the agreement is unlawful. Nevertheless, the courts of a few jurisdictions, professing, as we have said, to see the bargain in the two parts indicated, find themselves able to separate the parts. Essentially, they must find, as a necessary concomitant of the promise to take the stock, an implied promise to pay the proper price for it. This constitutes one part of the agreement. Also, they find the second part of the agreement to be that the proper price shall be the offered value.

Even though the offered price be a fair price in the sense of being all the shares are worth, still, it is not the proper price if the statute requires a value equal to par. Also it is not a fair price in a sense we will discuss later.

In this third type of jurisdiction the courts read into the first part of the agreement, as the proper price, the price that ought to be paid, namely, a value equal to the par of the stock; and they declare that the second part of the agreement is invalid, and enforce only the first part.

Such a splitting up of the agreement seems absurd. It was, in simple fact, understood that the shares were to be issued in consideration of the offered value. Since the consideration is unlawful, the entire agreement, it would appear, should be unlawful. However, those jurisdictions which laboriously find a lawful part and an unlawful part of the agreement, so independent as to be separable, come to a just result by an erroneous method.

The conclusion of the law, that an illegal consideration results

in an unlawful agreement, looks merely at a state of facts in which one individual arrives at a bargain with another. When courts apply it to the corporate capital stock situation, they overlook the very pertinent fact that, by virtue of the corporate capital stock concept, stockholders and creditors are also vitally interested.

We get into an extremely complex situation, with results that show how crude an instrument the corporation still is. Much development work remains to be done. Though presumably the work will not break with principles through which justice has been sought in the dealing of individual with individual, it must modify or add to these principles to do justice when one of the contracting parties is not an individual, but a group, and creditors contract with the group on the liability terms of corporate capital stock. Once more our "as if" reasoning of corporate entity or personality has led us astray.

Let us go on with our problem of the members of the stockholder group as related to each other in connection with the concept of corporate capital stock. Then we will further consider the relation of creditors to them in the same connection.

In so far as the sanctions of the law apply, the concept of corporate capital stock is of statutory creation. And we will now deal only with statutes which limit the authority of the corporation to the issuance of shares of common stock of a stated par when, in consideration therefor, the corporation receives assets of a value equal to the par of the stock. Therefore, an issuance of shares of a stated par, without the receipt of the equivalent asset, is an act outside the authority which the State has given the corporation. It is *ultra vires*, and the directors as agents of the corporation cannot have authority to do that which their principal, the corporate group itself, has no authority to do.

SETTING THE TRANSACTION ASIDE

If the agent-directors exceed their authority, and issue par stock without receiving the equivalence in value, the general principles governing *ultra vires* acts apply. After the property is received and the stock issued (when, in the language of the law, the contract is executed), the transaction itself stands. It will be observed that the agency doctrine of ratification does not apply. The act is illegal, and the principal, the stockholder group, cannot make lawful an act which the State has made unlawful. And a

man who purchases stock with property of a value less than the par of the stock is a party to an unlawful statutory act. He is as chargeable with a knowledge of the value of the property as the directors.

At this point there is perhaps a hiatus in the logic of the law applied, and perhaps not. As a general principle, the forces of the law may be brought to bear to prevent the commission of such an unlawful act, but if the act has been completed by the two parties to it, neither will succeed in an application to have the forces of the law brought to bear to undo it. The parties are *in pari delictu;* neither can come into court as the innocent injured party.

But the stockholders (we will assume) have been no party to the act. Why should not their innocence permit them to come into court and ask to have the act undone? Essentially the directors and the purchaser of the stock for an inadequate value have conspired to become a party on one side wilfully to commit an unlawful act, in which the party on the other side, the stockholder group, is essentially innocent.

Nevertheless the current of the law generally takes the *pari delictu* course, viz.: when directors issue stock for a value less than an equivalence of the par of the shares they are violating a duty, but they are in fact acting for the corporate group. The stockholders appointed their directors agents, and should not have appointed agents who would act in this way — agents who will be held responsible for their act to the extent that they will not be successful in an application to the courts to undo the act after its completion. In the language of the law, they may not rescind the contract and demand that the certificate for the shares issued be returned for cancellation on the retransfer of the property paid for the shares.

It is submitted that this is an incorrect conclusion. The subscriber to the shares knows that the directors are acting without authority. Other members of the stockholder group are innocent.

However, the law will interfere in any case to prevent the commission of the unlawful act. If the directors and the property owner have entered into their contract, but none of the property has been transferred to the corporation and no stock issued, then the courts will grant an injunction restraining the directors, and perhaps the property owner (if the court can get jurisdiction over him), from carrying out the unlawful act they have agreed upon. Stockholders who will be injured may act to prevent its commission.

SHAREHOLDER ACTING FOR THE CORPORATION

They cannot prevent its commission by simply refusing to act themselves, for the matter is in the control of their agent group of directors. And this fact results in an interference with the orderly course of corporate procedure under which the group acts by its director-agents, as the only normal course of group functioning. In normal functioning not even the entire group in unanimous agreement can act directly. It must act through its agents. But here the directors are to be prevented from acting for the group, which must function abnormally if it is to function at all. So the group is permitted to act directly under these circumstances which require direct action.

Must the group act unanimously by, say, every stockholder executing the petition to the court? Such a requirement, besides being practically prohibitive in the case of a large group, might defeat the ends of justice. A wrongful act is proposed. It may be that some, even a majority, of the stockholders are acquiescent. Indeed, the very man to whom the stock is to be illegally issued may already be a member of the stockholder group. So any one or more stockholders are permitted to make the petition on behalf of the group.

And likewise, until the contemplated illegal action of the directors is completed, until the whole property is transferred to the corporation, and until all the stock to be issued therefor has been issued, a stockholder may apply to have the agreement set aside, the certificate for stock surrendered and canceled, and the property retransferred. The petition might also include an application for an injunction restraining the man to whom the stock was issued from disposing of his stock, and the directors from disposing of the property. If the man to whom the stock has been issued has sold his shares to a purchaser who knew nothing about the illegality of the agreement on which it was issued, it will be too late to undo the transaction. Or, if the directors acting for the corporation have sold the property to someone who was unaware of the illegality with which the title was tainted, it will be too late. The corporation and the man with whom the directors dealt cannot be restored to their original position: the transaction cannot be specifically undone.

Circumstances might be such that the corporation could function normally. If the term of office of the board of directors which

entered into the illegal transaction came to an end before the transaction was completed, a new board of directors elected by the stockholders might act to undo the transaction of the previous board. This remark of course applies to all matters which give rise to the right of a stockholder to take legal action on behalf of the group.

But assume the illegal issuance of stock for the transfer of property not equivalent in value to the stated par has been completed, so that proceedings to undo the transaction cannot be taken. An injured stockholder ought to be able to take them whenever the parties can be restored to their original positions, no matter if performance under the agreement has been completed. However, though it may no longer be possible to undo the transaction, it does not follow that the wrong to stockholders (and creditors) must be without a remedy. And the remedy may actually exist in a jurisdiction which attains justice, even though it be by an erroneous process of reasoning. Before going on to the proceeding to be taken, let us consider again who are injured. All existing stockholders who have paid the full par equivalence for their stock, and all future stockholders who pay that equivalence, are wronged.

THEORY OF EQUALITY OF CONTRIBUTION

Share for share the stockholder who has not paid the full par value for his shares has not made the same contribution to the enterprise as the man who has paid the full par value. Par value shares stand on the theory of an interest in the enterprise proportional to a constant of capital contribution to the enterprise. Though this theory, as we shall see, has been whittled down in various ways, so that it hardly affords standing room, it nevertheless appears to have a real existence. Stockholders contribute nothing but capital. Partners' contributions of service may be of different values, and may justify sharing in proportions differing from those of their capital contributions. But shareholders as such contribute no services.

To be sure, after the first stockholders have made their contributions, the enterprise may suffer losses. Let us assume a concrete situation: on organization, subscribers who took and paid for 1000 shares at $100 a share may carry on the business for a year at a loss of $20,000. So at the end of the year the corporation has a deficit of that amount, and the asset value per share of

stock is only \$80. The directors then desire to provide more capital for the enterprise to the amount of \$50,000. Since the shares are of the par of \$100 they cannot be sold for less than that amount. If 500 shares could be sold for \$100 a share, providing the desired \$50,000, the result to the corporation would be:

Net worth	\$130,000
Capital stock	150,000

or an asset value of \$86.66⅔ a share.

The capitalists approached naturally ask why they should make a capital contribution of \$100 a share that will result in their getting stock with an asset value of only \$86.66⅔, and in increasing the asset value of the stock of the existing shareholders from \$80 a share to \$86.66⅔ a share. The directors, speaking for the present stockholders, may answer that the capitalists will be buying an interest in a business which has taken the hard knocks of initial enterprise, and is about to transmute losses into profits. They may not be able to point to any achievement which would justify an entry of good will of a value of \$20,000; still there is, so to speak, an experience value, which cannot be entered as an asset but, nevertheless, exists. Though the capitalists may not be willing to grant the soundness of this argument, it is the reasoning back of the theory of constant equality of contribution for equality of interest. When we come to consider no par shares we will see that adopting them as the base of a corporation's capital stock structure discards the constant equality of contribution theory.

RIGHTS OF INJURED STOCKHOLDER

So in a constant equality of contribution theory (on which par value shares stand), the issuance of shares for value less than their par equivalence wrongs all existing stockholders who have paid the corporation the full par value, and all future stockholders who may pay to the corporation such par value. Assignees of stockholders who have purchased their shares directly from the corporation step into the shoes and have all the rights of their assignors.

Though the wrongful agreement for the issuance of stock for property of a value less than the par of the shares has been completed by the transfer of the property and the issuance of the certificates, and the transaction, therefore, cannot be undone, nevertheless it has wronged present and future stockholders paying

the full par value for their shares. The directors and the man to whom they issued the certificate of full paid stock, which was not full paid in fact, have, to speak loosely, committed a fraud on stockholders paying in full.

Perhaps we need to delay here to consider how an act may wrong someone who did not exist at the time the act was committed. In our particular instance the matter goes back to our viewpoint of the corporate group. As we saw, the partnership group is looked at from a viewpoint which sees the individuals composing the group, so that if the individuals change we no longer see the same group, but a different group. The corporate group is looked at from a viewpoint of group pattern, which overlooks the individuals comprising the group, and sees that a group conforming to pattern continuously exists. So that a wrong done to the corporate group is looked at as a wrong done, not only to the existing members, but to all future members.

When an existing member assigns his shares one might casually, but not perhaps with complete accuracy, assume that he assigns also his right to his remedy for the wrong done him. And in effect he does. He cannot separate his rights as a stockholder; he cannot assign his right to be a member of the group and retain his remedy for the wrong. And this is so even though it might be quite possible to compute the damage done to him individually. If he receives a lower price for his stock by reason of the wrong done the corporation by the issuance of full paid stock for a value less than its par, he has suffered his damage and parted from his remedy. The wrong done is not, if one may coin a phrase, a joint and several wrong, but a joint wrong only; and the remedy is not joint and several, but joint only. Though a single stockholder may seek it, he does so, not on behalf of himself alone, but on behalf of himself and his fellow stockholders together.

The man who sold his property to the corporation has not fulfilled the conditions for becoming a member of the group with an interest of the magnitude he has obtained. As a member of the group he owes a duty to his fellow members to contribute his pro rata, the par constant of contribution, to the enterprise. They, represented by one or more of their number, ought to be able to compel him to perform this duty.

It must not be assumed, however, from this statement, that a stockholder generally occupies a fiduciary relationship to his fellows similar to that of a member of a partnership. For example,

much more than adequate, may be entirely inadequate. Suppose the stock were worth in the market $200 a share, though the par value is $100, and the directors issued shares of the aggregate par value of $200,000 and a market value of $400,000 for the property worth only $100,000. The transaction injures creditors merely because the represented $200,000 of capital stock has not been created. But stockholders have suffered a present diminution in the value of their shares, and in equity it will be held that the new stockholder, who has paid only $50 of value for each share he has received, should pay, not just the difference between that and the par value of $100, but the difference between $50 and the fair value of $200.[1]

Some stockholders may not be in a position to act for the group in pursuing the several remedies indicated. If a stockholder has consented to, acquiesced in, or approved the transaction he may be "estopped" to deny its validity; and if he is so estopped, his transferees will be likewise estopped. This estoppel of the transferee seems hardly consistent with the idea that the wrong is a wrong to the group jointly and not to the several separate members, and looks as if the matter were placed on the basis of an individual right, and the estopped stockholder, having lost, or not having acquired, the right, does not possess it to pass on to a transferee. To say that he has lost, not his right to have the equality of contribution maintained, but his right to represent the group, seems inadequate. An innocent transferee is not tainted with the conduct of his transferror.

STOCKHOLDERS AGAINST DIRECTORS

Directors violate a duty they owe the group, if they issue stock as full paid, when in fact the shares are not full paid. The group, represented by one or more of its members, should be able to hold the directors responsible for their failure to perform their duty. If the directors issued full paid stock on only part payment, those who caused the stock to be issued, and, it may be, those who negligently permitted it to be issued, can be made to pay to the corporate group that which they should have required to be paid, and did not — the difference between the value of the property received and the amount of the stated par of the stock issued.

[1] Victor Morawitz, *A Treatise on the Law of Private Corporations*, Second Edition, Vol. I, Sec. 289, p. 290.

LAWFULNESS OF CONTRIBUTION OF VALUE LESS THAN PAR UNDER DOCTRINE OF NECESSITY

Any consideration of the concept of par value capital stock must take cognizance of the idea, ever lurking in the shadows of the subject, that a corporation, when in a financially embarrassed situation, may issue shares, by virtue of necessity, as lawfully full paid, though a value equal to par has not been contributed. Such violence to ideas about statutory mandate and other doctrine arrests attention and arouses wonder. Presumably those cases which permit a limitation of creditors' rights under such circumstances, in principle also would limit stockholders' rights.

One is inclined to query whether the necessity is always real. An inability to sell stock at par on the existing facts does not alone prove it. If the situation is such that a proceeding to reduce capital stock can be taken, the reduction, with a corresponding change in the shares, might lift the value per share above par.

In such a case the issuance of stock for less than par is not absolutely unavoidable; only convenient. Is the value of the convenience of such a kind as to make the invading doctrine desirable? One parodies the question of Pontius Pilate with "What is necessity?" Should one go as far as Voltaire's magisterial remark to the culprits who pleaded before him that they had to steal in order to keep from starving — "Je ne vois pas la nécessité"?

Does the doctrine of necessity destroy more than one part of the concept of par value capital stock? The fund, to be sure, is not created, as otherwise it ought to be, at the time of issuance. But have not the directors indicated the measure which is to be filled with value before any distribution to stockholders? Since the asset acquired is of a value less than the par, does it not create a deficit? One assumes that it does. One queries to what extent it is given recognition.

We shall see the financial embarrassment theory cropping up in reorganizations, in connection with which we will give it further consideration.

RIGHTS OF CREDITORS

Let us next consider the position of those who have claims against the corporation arising out of contract or tort, for which they have a right to satisfaction out of its assets. Whatever the origin of their claims, we class all such people as creditors. The

very reason why the State requires the statutory group to create its capital stock fund, which it may not voluntarily diminish without the consent of the State, is for the protection of these creditors. But the only responsibility that the State places on an individual member of the group for the establishment of the fund is that he shall pay his share. He has no duty to see that his fellow members pay their shares of the contribution to the fund. If, when he has *agreed* to pay his share, he does not pay it, his liability to the group for payment in full is an asset of the corporation, and its creditors are entitled to have the corporation receive such payment so that it may be applied to the satisfaction of their claims. Any creditor may enforce this right by legal proceedings.

RIGHTS OF CREDITORS ON ISSUANCE OF FULL PAID STOCK WHEN VALUE EQUAL TO PAR IS NOT GIVEN

Already we have seen the extent of the responsibility to stockholders of one who on becoming a member of the corporate group *does not agree* to contribute a value equal to the par of the stock issued to him.

What are the rights of creditors in this situation? [1]

(1) If the stockholder group has a right, which is of value, that right is an asset of the group enterprise; and creditors in turn have a right to have the value of that asset realized for the corporate fund, and appropriated towards the satisfaction of their claims. Such a proceeding would be for the equal benefit of all creditors. But the value of a right to have the transaction set aside, and the parties placed *in statu quo*, has disappeared before it could possibly be of any advantage to creditors. They have not been paid because the corporation is insolvent, and its shares are valueless. For the corporation to restore property, and take back shares of its own stock, would not increase, but reduce, the assets available to creditors.

(2) On principles we have already indicated, whether resting on the trust fund, fraud or misrepresentation ("holding out"), or other non-statutory doctrine, where it has been adopted, a creditor can proceed directly against the stockholder who has not contributed the value he ought to have contributed. It must be

[1] See James C. Bonbright, "Shareholders' Defences against Liability to Creditors on Watered Stock," *Columbia Law Review*, April, 1925, Vol. XXV, No. 4.

clearly kept in mind, however, that this is a different kind of proceeding from that indicated in (1), which is sometimes called a receiver's action, as enuring to the benefit of all creditors; and that this proceeding under (2) may be taken by, and enures to the benefit of, only those who became creditors after the unlawful transaction of issuing shares as non-assessable, when, in fact, a value equal to the par had not been contributed.

We must remember, too, that some jurisdictions — for example, New York State — do not recognize the non-statutory doctrine of (2).

(3) In a majority of States (including New York) explicit statutory enactments make stockholders liable to creditors for the difference between the contributed values and the greater par of the shares issued therefor.

Here we immediately have a question. Are they liable to all creditors or only (in effect) to subsequent creditors, i.e., to those who become creditors after the transaction? Courts of some jurisdictions say we have merely a codification by statute of the non-statutory principles set forth under (2), and that therefore only subsequent creditors can sue; courts of other jurisdictions say that we have a positive new rule, a statutory change in the law, and that any creditor, antecedent as well as subsequent, can sue.

Despite a prima facie liability, the stockholder may have various defenses:

(a) A creditor may have waived his rights. We see the most conspicuous example of such waiver in the clauses inserted in bonds, and in the trust indentures under which they are issued, expressly providing that the bondholder shall not have recourse to stockholders. A defense of waiver based on this clause is generally sustained.

(b) Stockholders may interpose the defense that the shares issued to them are entirely invalid. If the shares are an overissue, i.e., beyond the amount authorized in the charter, the courts generally sustain the defense. But if they rely merely on the unlawful issue of authorized shares for which the corporation has received some value, though not in an amount equal to the par of the stock, they generally fail. In the case of unit sales, as of a $1000 bond and $1000 par of stock for $1000 in cash, the payment ought to be regarded as in part for the fair value of the bond and the rest for the stock, so that the corporation has received some value for the

shares. The word "bonus," however, usually gets into the minds of the judges, and they do not see anything paid for the stock. If in actual fact nothing has been paid, or, with the same result, as in the case of unit sales, the court finds no payment for the stock, some courts treat the shares as invalid and sustain the defense; other courts, with better reason, deny the defense and hold the purchaser for the price. In the case of unauthorized stock, the creditor could at least see the amount of overissue, and know that invalid stock was outstanding to that extent. He has no such means of knowing the fact of failure to pay any value at all for authorized stock.

(c) The creditor might find himself confronted with the defense that the corporation issued the stock at a time when it was in financial difficulties, and, pressed with the need of funds, could not raise them by the sale of stock unless it issued the shares for a value less than par.[1] And this defense, though a serious invasion of the general principles of par value corporate capital stock, has been allowed in some jurisdictions.

CREDITORS AGAINST DIRECTORS

As we have seen, those directors who are responsible for the issuance of stock as full paid, which was not so in fact, can be held liable by the stockholders for the deficiency in the payment. Can creditors correspondingly hold such directors liable? The answer may be important. Even where the delinquent stockholder is liable, he may not be able to respond to his liability with payment, but the directors, whom the stockholders may hold, may be able to make substantial payment and, perhaps, payment in full. Though the stockholders may be able to proceed against the directors, it may be that no stockholder will choose to exercise his right. Unless, as a result of the proceeding, the corporation will be able to satisfy creditors in full and have something left for stockholders, they have no incentive to press a claim against directors.

The directors, as agents of the stockholders, have a duty to them to see that proper payment is made for stock issued as full paid. Though the very purpose of the statutory requirement of

[1] See the discussion of *Handley v. Stutz*, 139 U. S. 417 (1891), 11 Sup. Ct. 530, in James C. Bonbright, "Shareholders' Defences, etc.," *Columbia Law Review*, April, 1925, Vol. XXV.

a capital stock fund is the protection of creditors, the directors are not agents of the creditors, who in their dealings with the corporation are on the other side of the fence from the stockholders and their director-agents. Yet, as we have already seen, various jurisdictions, recognizing that the essential purpose of the fund is to protect creditors, as the directors know, create a statutory liability of directors to creditors.

CONTRIBUTION THEORY IN CONNECTION WITH INITIAL PAID-IN SURPLUS AND WITH JURISDICTIONS WHICH PERMIT DIRECTORS TO FIX SUBSCRIPTION RIGHTS ON ADDITIONAL ISSUANCE AT MORE THAN PAR

Those jurisdictions which permit a corporation to place a preemptive price on stockholder subscription rights at greater than par abandon part of the theory of equality of contribution. The theory has changed from one of an absolute constant of equality to one of minimum contribution.

If the corporate group on organization pays a premium in order to create a paid-in surplus, the members have voluntarily taken the position that though they are paying $125 a share, subsequent contributions may nevertheless be not more than $100 a share. This may have the result that some members of the group, as it subsequently exists, will not be on a basis of having contributed as much as those who first came into the group. But the action is voluntary and unanimous.

To make the situation specific, assume that when a corporation just organizing opens its books for subscription, 10,000 shares of the par value of $100 a share are subscribed and paid for at $125 a share. Two stockholders, A and B, have each taken 100 shares, therefore each contributing $12,500. Subsequently the corporation offers its stockholders 1000 additional shares at $100 a share. Then A and B have each a right to subscribe to his pro rata of 10 shares. If both subscribe, each will contribute $1000 more to the corporate enterprise, and each will still own a one-hundredth interest, for which each will have paid an aggregate of $13,500.

Let us assume that at the time of this offer of additional shares the stock was selling in the market at $100 a share, so that the right to subscribe has no value, and therefore cannot be sold, and that B does not subscribe. On B's failure to exercise his preëmptive right, let us assume that the corporation sells the shares to

someone for $100 a share. The new stockholder has then acquired a one-thousandth interest in the enterprise for $1000 whereas an equality of contribution would require the payment of $1350.

So we find that the initial members may abandon, and a jurisdiction which permits directors to fix a price of subsequent issuance above par does abandon, the theory of a constant of equality of contribution, for what is essentially a theory of minimum contribution.

We may seem to be harping wearisomely on the theory of contribution. But we dwell on it because it seems to be the only real basis of a par requirement. All that creditors need is the creation of a capital stock fund, and that they can have with no par shares.

TREASURY STOCK

May a corporation which has issued shares of stock afterwards acquire them for itself? Generally it may, if the acquisition does not result in an impairment of the capital stock of the corporation. If the owner offers to give them back, the corporation may accept the gift. The donation does not diminish the assets of the corporation. Even though the shares were only part paid, presumably the corporation may accept a gift of them. The liability of the donor to make payment would remain, and the assets of the corporation not be diminished.

If a corporation buys its own stock, the directors must not by their act diminish the capital stock values in the corporation. They may buy only out of surplus. They are not acquiring an asset by the purchase, and anything paid out by the corporation in the acquisition of its shares reduces its assets. Consider the matter in the concrete case of a corporation in the position of having neither a surplus nor a deficit:

Assets		*Liabilities*	
Cash	$ 20,000	Capital stock	$100,000
Plant, etc.	80,000		
	$100,000		

Assume that the capital stock is represented by 1000 shares of the par of $100 a share, and that the corporation purchases 100 shares at 100. Its position will then be:

Assets		*Liabilities*	
Cash	$ 10,000	Capital stock	$100,000
Plant, etc.	80,000		
Treasury stock, 100 shares	0		
Deficit	10,000		
	$100,000		

As we have seen, it is a fundamental principle of capital stock that once issued it remains constant — it is a measure of value which the corporation must have more than full before it can make any distribution to stockholders. The stock purchased cannot be an asset to the corporation. It was, to be sure, an asset of the stockholder, his property, evidence of his interest in the business. But paradoxically the corporation (if for the moment we may regard it as an entity) can have no interest in its own business; the entire interest in the business belongs to the stockholders. Shares of stock represent the duty of the group on liquidation of its enterprise to pay out to members of the group their pro rata of the values remaining after all creditor claims are satisfied, and until liquidation to pay them pro rata any distribution properly made to members. The corporate liability to creditors is to exhaust all assets, if necessary, to pay them. The corporate liability to stockholders is conditional, but its liability to creditors is absolute. The conditions are (1) while the enterprise is a going concern to pay dividends, if payment will not impair the capital stock, and if in the sound discretion of the directors payment is expedient; and (2) when the enterprise is in liquidation to pay its remaining assets, if any, to the stockholders, after all creditors are satisfied in full. But, subject to the conditions, the liability to stockholders is a liability, a thing owed. A man cannot owe himself money. If on good consideration he delivers his promissory note for $1000 to another, the note is not an asset in the hands of the maker, but merely a spoiled piece of paper. So the corporation cannot owe itself on its own note; and it cannot owe itself on its own shares of stock.

If one stockholder should donate his shares to the corporation, what happens is, not that the assets of the corporation are increased, but that the shares still outstanding are enhanced. Assume the following:

Net worth of corporation	$100,000
Capital stock (outstanding 1000 shares)	100,000

This shows an asset value of $100 per share. If a stockholder donates 100 shares to the corporation the result is:

Net worth of corporation	$100,000
Capital stock (outstanding 900 shares)	100,000

So the asset value per share of outstanding stock has become $111.11.

Let us consider a purchase of stock for the treasury, and take for illustration a corporation in the following position:

Net worth of corporation	$150,000
Capital stock	100,000
Surplus	50,000
	$150,000

This makes an asset value per share of $150. Assume that the stock, for whatever reason, is selling in the market for $125 a share. At this price on the above statement the directors could buy for the corporation up to 400 shares at an aggregate cost of $50,000, which would exhaust the surplus but leave the capital stock unimpaired.

Conceivably circumstances might exist in which it would be appropriate for directors to cause the corporation to speculate in its own shares in the interest of the stockholders, but such speculation is to be viewed with suspicion. Though the corporation may have authority to engage in it, nevertheless it is not an integral part of the conduct of the enterprise. If the surplus is not needed for the fundamental purpose of the business, the directors would do better to distribute it to the stockholders, and let them exercise their individual judgments as to the desirability of speculating in the shares of the enterprise, instead of the directors imposing their judgment on the stockholders. And if the directors feel that the surplus may again be required in the business, they had better keep it by some form of investment that will be an asset.

Question arises as to why a stockholder should ever donate his stock to the corporation. Generally no one stockholder would make such a donation when it would result in his detriment and solely benefit his fellow stockholders. But in the promotion stage of an enterprise such a result may not follow. Let A be the principal promoter of a corporation of which A, B, and C are the incorporators, A agreeing to take eight shares and B and C each

agreeing to take a share. If A then sells certain property to the corporation for 200 shares of its stock of the par value of $100 a share, and donates 100 shares to the treasury of the corporation, he does so at no substantial detriment to himself. He owns 108 shares of the total of 110 outstanding instead of 208 out of 210. If B and C have assigned their shares to A, he suffers no detriment whatever. He owns all the outstanding shares of a corporation which owns the property, and is just as well off after his donation as he was before a capital stock fund had been created; and the situation stands, we will say:

Assets		*Liabilities*	
Cash	$ 1,000	Capital stock	$21,000
Property	20,000	(issued 210 shares, out-	
	$21,000	standing 110 shares, in	
		treasury 100 shares)	

Then on a sale of, say, 50 shares of the treasury stock for cash at $75, an aggregate of $3750, the situation becomes:

Assets		*Liabilities*	
Cash	$ 4,750	Capital stock	$21,000
Property	20,000	(issued 210 shares, out-	
	$24,750	standing 160 shares, in	
		treasury 50 shares)	
		Surplus	3,750
			$24,750

Treasury stock, once legally acquired by purchase or gift, can be resold by the company without reference to the par value, for full value has once been paid in.

So, though a subsequent sale of the treasury stock at $75 casts suspicion on the valuation of $20,000 placed on the property for the issuance of stock, it is by no means conclusive evidence of overvaluation. Assuming that on organization A became the owner of all the shares, he still owns 110 of 160 outstanding. He may have such faith in the success of the enterprise as to believe that he will ultimately be the gainer by his immediate sacrifice in value. Before the sale of the treasury stock the balance sheet asset value per share of the 110 outstanding was $190.91 for the aggregate of $21,000 in value. After the sale of 50 shares of the treasury stock at $75, the asset value per share becomes $154.69 for the aggregate value of $24,750, of which A's 110 shares repre-

sent $17,015.90 of value, or a loss to A of $3984.10, which he is prepared to take for the sake of providing the $3750 of additional capital in the enterprise. Before the statutes authorized the issuance of no par shares, the promoter who wished to gain this possibility of the sale of shares by the corporation for values less than the par of the stock had to resort to the device of treasury stock. In no other way could par stock be sold below par by the corporation without running the risks of liability of the directors and purchaser to the stockholders and creditors as previously outlined in this chapter. To achieve this and other purposes of capitalization, doubtless directors often took large hazards in the values they placed on property purchased by the issuance of stock.

CHAPTER XI

Stock Without Par Value

Protection of creditors through the creation of a fund, which the statutory group may not voluntarily reduce without the consent of the State, is one of the principal elements of the corporate problem. If the fund is in fact established, and not voluntarily reduced without such consent, all that the State seeks to accomplish for creditors in connection with the corporate form of business organization as distinct from other forms is achieved. Shares of stock are simply a convenience for measuring the interest of each member of the group in the enterprise, for transferring that interest, and for dividing it. By this device the number of members of the group may easily be increased or diminished and the interests of existing members changed.

Only a theory of a constant of equality of contribution for equality of interest requires that the shares have a par value. Par value means, of course, not at all the market or intrinsic value of the shares, but the value which the corporation must receive for the shares in order that equality of contribution for equality of interest be maintained. A share of stock represents the smallest division of interest which a corporation is authorized to make. Situations frequently arise, as in the declaration of a stock dividend, or on the shareholder's right to subscribe to additional stock, which create fractions in relation to shares. But such fractions do not constitute a shareholder's interest in the enterprise. A man who holds only a fractional right is not a member of the statutory group. He is entitled to become a member only when he assembles enough fractional rights to hold the full right to have a share issued to him.

Endeavor of promoters to provide for division of interest in the enterprise, without adequate regard for the safeguards by which the State, through a par value of shares, seeks to protect the principle of equal contributions for equal interests, is the most frequent cause of watered stock. When we come to a con-

sideration of shares without par value we find the State permitting the organizers of corporations to abandon the theory of a constant of equality of contribution and elect an entirely different theory. This is as it should be. It is only the members of the corporate group who are concerned with their respective interests in the enterprise and the manner in which they arose.

If those who formulate the group, who are the group in its initial membership, do not care to stick to the idea of interests in proportion to contributions, why should they not depart from it? At the moment they are the only people concerned. When new members purchase interests in the enterprise, whether directly from the corporation, or by assignment from an existing stockholder, they know they are entering a group which is not formed on the principle of equality of contribution.

Very practical exigencies arise which make the principle of equality of contribution difficult of operation. When stock of a corporation of the par value of $100 a share is actively bought and sold in the securities markets at $80 a share, or less, the state of mind of the man who might commit funds in the enterprise is certain to be that whatever the amounts per share of the contributions previously made may be, the present value of those contributions, against which he is to match his, is appraised in the market at $80 a share. In any event he will not contribute a greater amount when he can buy in the market for $80 a share all the stockholder values existent in the enterprise. He is likely to be skeptical about the experience values inherent in losses. If they are there, he will not pay for them when he can get them without payment.

Promoters can, as far as the law is concerned, achieve with no par value shares anything they can obtain with shares of par value in preparing a plan of capitalization to apportion the incidents of risk, income, and control.

If the State does not make adherence to the theory of equality of contribution compulsory on the group, apparently there is no reason why, as among themselves, they should cling to it if they do not want to. And now in most jurisdictions the State does not require such adherence. The history of State authorization of the use of shares without par value is an interesting case of social adoption of an idea, not on its merits, but through forces unrelated to the value of the idea itself. The late Edwin M. Shepard, an attorney in New York City, advocated the use of

shares without par value for many years before any State authorized their use.

Finally the State of New York in 1912 enacted what was called a no par value statute. It required, however, that the value received on the issuance of so-called no par value shares should be $5 a share or some multiple thereof, which in effect established a minimum par of $5. Subject to this limitation, the certificate of incorporation might state the consideration on which the shares could be issued. Obviously, if it contained such a statement, the amount indicated became the par of the shares just as much as if the certificates issued set forth a par. But the certificate of incorporation might authorize the directors to fix the value on which the shares could be issued. Still the minimum limit of $5 a share existed. If the certificate of incorporation did not specifically confer authority on the directors, it was necessary for them to get the consent of the holders of two-thirds of all classes of shares expressed in a stockholders meeting.

Those who had advocated shares of stock without par value were aware that this was an unsatisfactory statute, and in 1917 procured a change which provided for true no par shares. As amended the statute contains the alternatives to an expressed par of: (1) shares for the issuance of which the certificate of incorporation requires a stated amount to be paid to the corporation; and (2) true no par value shares for which: (a) the certificate of incorporation may expressly authorize the directors to fix the issue price, or (b) the directors may issue the shares at their fair market value, of which, in the absence of fraud, their judgment is conclusive, or (c) the stockholders may determine the price by vote of the majority of shares entitled to vote. Since a price per share stated in the charter is only a form of par value shares without requiring the words "par value" to appear in the stock certificate, it is obvious that division (1) above is of no practical advantage.

Other States were not quick to follow the lead of New York. However, a situation arose which presumably gave the impulse which brought a procession of States to adopting amendments of their corporation statutes to provide for no par shares. The period of the World War was a time of rising commodity prices, rising wages, increasing dollar profits in many lines of business, and a correspondingly rising dollar value of fixed capital assets. The situation aroused speculative interest and the response, on

the part of many corporate owners, of a desire to sell all or part of their ownership in their enterprise on what they regarded as the advantageous terms of a high price level. Promoters and dealers in securities, seeing an opportunity to profit, stimulated the desire of owners to sell and brought it to realization.

But a difficulty intervened between the will to sell at a profit and its fulfillment. Would the sale realize to the owners a net profit approaching the gross profit indicated by the terms offered? Under the influence of the voracious demand for revenue which came with the war to the Federal Government, it increased the rates of tax on income; and income included profits on the sale of capital assets. There was then no ameliorating capital-gains tax, afterwards existing for a time, which could be taken advantage of to keep such gains out of general income, taxable at the rapidly progressive rates, and put them in the special position of being taxable at a flat rate; there was then no ameliorating classification of capital gains of which only percentages are included in the base for taxation as at present. Could owners of corporate enterprise afford to realize the offered gross profits, or had they better continue their existing ownership?

In finding the answer to this question another question arises: When is a profit realized? When, in the language of the tax law, is a transaction "closed"? If a man who has bought a share of stock for $105 sells it for cash of $150, he has without doubt made a profit of $45. But if he bought a share of stock for $105 cash and exchanged it for a share of stock in a different corporation, which had a market price of $150 a share, the revenue act provided that the transaction was closed, and the $45 profit made, just as if the sale had been made for cash. There were, however, certain exceptions, one of which is pertinent to our present consideration. To quote the Federal Revenue Act of 1918:

> When property is exchanged for other property received in exchange, it shall for the purpose of determining gain or loss be treated as the equivalent of cash to the amount of its fair market value, if any: but when in connection with the reorganization, merger, or consolidation of a corporation a person receives in place of stock or securities owned by him new stock or securities of no greater aggregate par or face value, no gain or loss shall be deemed to occur from the exchange, and the new stock or securities received shall be treated as taking the place of the stock, securities or property exchanged.[1]

[1] Federal Revenue Act of 1918, Sec. 202, 2 b.

This provision remained in effect in this form till the Revenue Act of 1921. Though the word "reorganization" is somewhat ineptly used, because it is desirable to limit its meaning to situations leading to the issuance of new securities as a result of judicial proceedings, the three words "reorganization, merger or consolidation" were interpreted to cover every feasible transaction through which it could be brought about that a new set of securities could represent the interests in an enterprise. If the owners of a corporate enterprise sold their stock or any part of it for cash, they would have "closed" a transaction and become taxable on any profits. If they voted as stockholders that the corporation should sell its assets for cash, then voted to dissolve the corporation, and the directors conveyed the assets, receiving and distributing the cash, the stockholders would have made a taxable profit.

But suppose a transaction were put through in such a way that the security holders received new securities instead of cash? Let us consider a specific example of a corporation with $2,000,000 of capital stock, represented by 20,000 shares, which the stockholders own at an average cost to them of $100 a share (or of that value March 1, 1913, back of which date the statute does not look). Let us assume that the business was in such a position of earnings, and, under the inflated values, of assets, that a new corporation could justify paying $3,000,000 for all the existing shares.

Security dealer promoters propose the organization of a new corporation to acquire all the shares of the existing corporation, for shares of the new corporation; and the promoters propose further to purchase part of the new shares for cash, thus enabling the stockholders to liquidate part of their interest. In short, the promoters want to make two shares grow where only one grew before, and make a profit out of marketing one of the shares.

If the new corporation issued $150 par value of its shares for each $100 par value of the old shares, the stockholder would have made a taxable profit of $50 a share. After the deduction of the tax, the net result of accepting the proposal well might not appeal to the stockholder. If, however, the new corporation issued one share of, say, six per cent preferred stock (or any class of stock) of the par value of $100 a share, and one share of common stock of no par value, for each share of the old stock, the two new shares would have no greater par value than the one

old share. The transaction came within the exception to the rule treating exchanges as sales, and closed transactions, on which the value of the new securities must be treated as a realized price and profits computed. It was "in connection with the reorganization, merger or consolidation of a corporation," and the stockholder received "in place of stock or securities owned by him new stock or securities of no greater aggregation or face value." No gain or loss was "deemed to occur from the exchange."

Then the security dealer promoters could purchase the 20,000 no par shares from the stockholders at, say, $45 a share and market them at, say, $50 a share, with a gross profit to the security dealer of $100,000. The stockholder would have $45 in cash and a share of preferred stock for each of his old shares. For tax purposes he would have to carry his share of preferred stock on his books at a cost of $55, which was the cost (or tax value) of his original share less the $45 cash he has received. He had not yet realized taxable profit. If later he should sell his share of preferred stock for more than $55, he would have to include the excess in his tax return as taxable profit. Until he did that he had no tax to pay by reason of the transaction. Since we are interested at this point only in the development of no par stock, possible variants from this plan of creating additional shares are not indicated.

Desire to effect such partial liquidation led to the seeking of a jurisdiction in which the number of shares could be increased without increasing the aggregate par value. To be sure, shares of the par value of $100 could be divided into two shares of the par value of $50 each and one sold with the same result in taxation. The old stockholder holding the new preferred stock, and the purchaser of the new common stock, would be getting exactly the same value whether (1) the new securities were 20,000 shares of six per cent preferred of the par value of $100 with a right to receive up to $100 a share in liquidation before any payment to common stockholders, and 20,000 shares of common of no par value, or (2) were 20,000 shares of twelve per cent preferred of the par value of $50, but with a right to receive $100 a share in liquidation before any payment to common shareholders, and 20,000 shares of common stock. Query: whether a right to receive two dollars in liquidation for each one dollar of par is consistent with the idea of par value. Presumably it is. Par value simply

indicates the equality of contribution and the measure of capital stock for creditors. It has nothing to do with liquidation preferences. But both the old stockholder and the possible purchaser of the new common would look askance at the unusual terms of the preferred stock in the second case, and the promoter would find it much more difficult to effect the transaction. It was easier to avoid resistance by the new idea of no par value.

So States authorizing the use of no par value shares found new incorporation business, and the revenue therefrom, coming to them. Other States desiring not to lose but to increase their business of incorporating adopted no par statutes. The idea of no par shares became familiar and even popular, so that issuers of stock frequently adopted them when par value shares would have served the transaction in which they were issued just as well. Within a decade after the first true no par statute in New York, thirty-eight States had enacted similar legislation.

It should be noted that nominal no par certificates of stock issued under a charter requiring a value there stated did not afford the means of effecting a non-taxable transaction such as we have considered. The Federal Treasury Department, correctly enough, took the position that a value for issuance required by the charter established a par value stock.

As already indicated, the very practical difficulty with the theory of absolute equality of contribution, or the modification of that theory to minimum contribution, is that if the general estimate of the worth of a share of the par value of $100 becomes such that no one will pay $100 for it, a corporation desiring additional capital in its enterprise is forced to follow some line of conduct it may prefer not to take. It must either:

(1) Go without the additional capital it requires; or

(2) Finance on creditors' securities with all the dangers of that course; or

(3) Procure the consent of the State for a reduction of capital stock so as to increase the worth per share.

This last alternative may need explanation which can more clearly be made by a concrete example. We will assume a corporation with a capital stock consisting of 10,000 shares of the par value of $100, an aggregate capital of $1,000,000. It desires an additional $500,000 in its enterprise, but its shares in the market are now being bought and sold for $75 a share. Since no

one will purchase shares from the corporation for $100 a share, it cannot, as matters stand, acquire its additional funds by the issuance of more stock. We will assume that the market appraisal of the worth of the shares and the net worth of the corporation coincide. That is, we have the following corporate statement:

Assets

Net worth	$ 750,000
Deficit	250,000
	$1,000,000

Liabilities

Capital stock (10,000 shares of the par value of $100)	$1,000,000

Assuming that the corporation is in such a condition that it can comply with the statutory requirements, it might reduce capital stock to $500,000, and carry the transaction through by amending its certificate of incorporation to change the par value of its shares from $100 to $50. The corporate statement would then stand:

Assets

Net worth	$750,000

Liabilities

Capital stock (10,000 shares of the par value of $50)	$500,000
Surplus	250,000
	$750,000

Since the market value of its $100 par value shares was $75, the market value of its $50 par value shares should be $75. That is, each $50 par value share still represents exactly the same values as its $100 par value shares represented. Now if the corporation offers additional shares of the par value of $50 a share for subscription, they should be taken by the stockholders, or be saleable by the corporation. Indeed, the new shares are really worth more to their holders than the old, because now the corporation will not have to make up the deficit of $250,000 before it can pay dividends. But besides the labor and delay of the procedure involved in this line of action, the corporation may not be in a condition to comply with the statutory requirements for it. We will not delay at this point to consider these requirements further than to remark that the State throws some protection

around creditors, who, except for the intervention of the State, would have a right to have the deficit of $250,000 made up, so that the capital stock of $1,000,000 would be unimpaired before any distribution could be made to stockholders.

If this third course of action is not open, the only way the corporation can provide itself with additional funds is by borrowing. Assuming that the condition of the corporation is such that lenders will take a chance for the promise of what they regard as an adequately compensating rate of interest, such borrowing may place the stockholder in jeopardy of losing their business on its failure to satisfy the maturing claims of creditors.

If, on organization of the corporation, those formulating the corporate group had an election to adopt either the continuous equality of contribution theory of par value stock, or to adopt the theory that contributions need not be continuously equal, but only that those made at a given moment of time should be equal and represent an equivalence of existing values, these organizers, foreseeing the position which, as just indicated, par value stock might put the enterprise in, well might elect to incorporate with a no par value stock authorized.

CHAPTER XII

Problems of No Par Stock

Although we can look back over the experience of a number of years with no par stock, it is, nevertheless, still a new design in the mechanism of the business corporation. In the beginning many people misunderstood the idea in certain aspects that seemed obvious to others. And it still requires the solution of various problems before men who have them to deal with can proceed with confidence.

Profits of an enterprise arise out of the energies of the managers in the use of capital. Men joining as partners contribute capital and energy. If they do not agree that the division of interest in the enterprise shall be in proportion to their capital contributions, it is because their estimate of their individual energies does not value them in this proportion. Members of a small partnership group are in sufficiently close communication to vary their agreement, if they want to. But their agreement is a real one of all their individual wills. It can be changed only with the consent of all. Since stockholders do not, as such, contribute energy, the only question of a proper share in the enterprise grows out of the capital commitment.

ISSUANCE OF NEW SHARES CREATES NEW RIGHTS

New members may enter a corporate group by either of the following ways:

(1) By assignment of the whole or part of the interest of an existing member, and transfer of the shares by the corporation. Such a change does not concern us at this point. It creates no new rights but only changes the ownership of existing rights.

(2) By the issuance of shares to a new member. This creates new rights. If a corporation has one hundred shares held by ten men, each owning ten shares, and each subscribes to an addi-

tional share, at a uniform price, the interests of the stockholders do not change. Each still has one-tenth of the whole. But if all the stockholders waive their rights, or do not exercise them, and the directors issue the ten shares to an eleventh man, the group relationship changes. The transaction creates a set of rights different from the former rights. Now each of the old ten members has only a one-eleventh interest instead of a one-tenth interest. For the sake of simplicity we have spoken in terms of a new member. Obviously, if through an issuance of new shares an existing member acquires more than his former ratio, the results are the same.

FIXING THE TERMS ON WHICH NEW RIGHTS MAY BE CREATED

On what terms may such a change in rights be permitted to take place? That is one of the problems. Who is to judge whether or not such an incoming member has made a just contribution of capital to the enterprise for the share he acquires in it? It would be inconvenient to assemble the entire body of stockholders to consider the terms on which the rights may be changed. And ought it be permitted that this particular change in the rights of the members themselves should take place without real agreement, the assent of every stockholder? As in other matters affecting the rights of members among themselves, should a two-thirds majority be sufficient to permit an effective will? Even so, the requirement might be too hampering for the exigencies of corporate action.

So, for practical purposes, we must have a rule, when the group is formed, regarding the terms on which the interests existing at any time may be changed.

THE PREËMPTIVE PRINCIPLE

We start with the preëmptive principle — that no such new rights may be created until the present stockholders have had an opportunity to maintain the existing interests. We have seen the invasion the principle suffers on the issuance of stock for property.[1]

[1] Adolf A. Berle and Gardiner C. Means, *The Modern Corporation and Private Property*, Commerce Clearing House, Inc., New York, 1932, comments

HOW A RULE OF CONTRIBUTION MIGHT BE ACHIEVED

A rule governing changes in interest might be achieved in any one of the following ways, or in some combination of them:

(1) The members of the initial group might arrive at it by contract, and express it as part of their certificate of incorporation;

(2) It might be left to the directors as agents having authority from all the members to make the bargain for the creation of the new interest;

(3) It may be fixed by statute.

Par stock obviously falls largely in (3), but partly in (2). Statute requires that the stock be not issued for a value *less* than par; but (subject to preëmptive rights) directors may fix a price above par. The statutory part of the rule proceeds on the principle that fairness requires that one who acquires a new interest in the enterprise shall contribute pro rata not less than the original contributions.

EQUITABLE PRINCIPLES

Beyond that the law leaves the matter to the directors. As agents of the group they, in honesty and to the best of their ability, must make the bargain fair to the members. Since more is being paid than the statute requires, only the principles of equity can, and they will, require the directors to see that enough more is paid.

Though the man bargaining with the directors does not owe the duty of an incoming partner not to make a secret profit, he

on the preëmptive right: "Stock issued for property is likewise not subject to the preëmptive right. No logical reason can be assigned for this exception, which came into the law through the hasty decision of a New Jersey Vice Chancellor, who was obliged to rule upon the point, having no more time for consideration than the lunch hour between sessions of the court; but it was promptly availed of by the Bar, and is recognized today despite its lack of logic." This comment cites *Meredith v. New Jersey Zinc Co.*, 55 New Jersey Equity 211, see *Wall v. Utah Copper Co.*, 79 N. J. Eq. 17 (1905), where the same Vice Chancellor recognized his mistake; see also A. H. Frey, "Stockholders' Pre-emptive Rights," *Yale Law Journal*, 1929, Vol. XXXVIII, p. 563. For purposes of our general theory we have assumed the existence of preemptive rights. But, as Berle points out, some jurisdictions take the position that there is no preëmptive right in authorized and unissued shares, but that it arises only on increased authorizations. And of course there is the possibility of waiver by charter provisions.

must bargain at arm's length. He must not conspire with them to disregard their duty. Such conduct would be fraud on the existing stockholders, and would expose the man acquiring the stock to attack for his wrong.

So, recapitulating, we have this beyond-the-statute situation:

(1) If the directors fail to perform their fiduciary duty of honesty and diligence as agents of the group, its members can hold them in damages for the breach. But if the person with whom they negotiate deals at arm's length, on such conditions as he would deal with a principal, he is not liable.

(2) However, if the person with whom the directors negotiate does not deal with them at arm's length, but conspires with them not to do their duty, both he and the directors can be held for their wrong, and the remedies would be:

(a) If the parties can be put *in statu quo*, rescission or damages at the election of the wronged stockholders;

(b) If the parties cannot be put *in statu quo*, damages only.

And we have seen that in equity the fairness of the bargain will be tested by the exchange of values. Are they equal? Is the consideration received worth the value of the stock? A par stock may require that it be worth more, i.e., the par of the stock when the stock is not worth par, with a consequence that no transaction results.

When the principles of equity are invoked, they disregard the theory of a constant equality of minimum contribution, for a theory, which, looking at the moment of the transaction, says the value of the contributions at that time must be equal. This is the core of the theory of no par stock.

OUTLINE OF PAR STOCK

Let us, as a next step in getting on with our discussion of no par stock, consider an outline of par stock.

One could not state in an outline of a hundred or so words the idea of corporate capital stock, and its implications, with sufficient fulness even to approximate the concept as developed in one jurisdiction; and it would be rash, indeed, to attempt an outline that would really be a generalization for our multiplicity of jurisdictions. Consider this outline as only presenting a theory of par value stock. As such it may be a sufficient guide for a discussion

of stock of no par value. In that, however, we will again be considering only a general theory. We have not yet had enough development to present a theory of the law of any jurisdiction.

We have, to start with, the matter of the measure of corporate capital stock, then the two aspects of the stock.

I. Creditors, contracting on the basis that the liability is limited to a contributed fund, have a stated measure of the size of the fund, which must have been created, and must not be voluntarily diminished. The measure is commonly the par of the issued stock. But under a statute authorizing directors to transfer surplus to capital stock without a stock dividend the par becomes only the minimum. The statutory line is almost obliterated.

II. Stockholder aspect:
- A. In the relation of stockholders to each other;
- B. In relation to directors;
- C. In relation to creditors.

III. Creditor aspect:
- A. In relation to the stockholder group;
- B. In relation to individual members of the group;
- C. In relation to directors.

STOCKHOLDER ASPECT

A. *In the relation of stockholders to each other.* They have a right against the person who has a duty to make a contribution, that he fulfil any duty at law which the statute may impose on him to make a contribution equal to the constant of the par of the stock required under the par value theory.

B. *In relation to directors.* Since the directors as agents of the stockholders owe them a duty to make a bargain which is fair to their principal, the stockholder group, if the directors fail of honesty or diligence, a stockholder on behalf of the group can sue them for damages.

C. *In relation to creditors.* Since stockholders have no rights against creditors, they having completely performed their contract by extending the credit, and therefore the stockholders have only to fulfil any duties they may owe creditors, we leave this topic to the correlative rights, if any, of creditors.

CREDITOR ASPECT

A. *In relation to the stockholder group.* The creditors have a priority right to have all the group assets applied towards the satisfaction of their claims.

B. *In relation to individual members of the group.* (1) Creditors have a right (to have the contributed value, transferred or agreed to be transferred, fill the capital stock measure at the time it is stated) against the stockholder who owes the duty to the creditor, as well as to the stockholder group, to make the contribution,

(a) which, in some jurisdictions he owes only to the subsequent creditor, i.e., to the man who became creditor after the duty to the stockholder group arose; but

(b) which, in other jurisdictions he owes to all creditors, antecedent as well as subsequent.

(2) In case the directors diminish the capital stock fund by distribution to stockholders, creditors have a right to recover the capital distribution:

(a) In some jurisdictions only against those who knew of the diminution at the time of distribution;

(b) In other jurisdictions against any who received the distribution, whether or not they knew of the diminution.

C. *In relation to directors.* Creditors have a right:

(a) That they fulfil a statutorily imposed duty to creditors to see that the measure of value is filled at the time it is stated;

(b) That they shall not by voluntary action diminish the contributed fund.

STATED MEASURE OF THE SIZE OF THE FUND WITH PAR SHARES

In the case of par value stock the aggregate of the par of the *issued* shares establishes the measure of the corporate fund for creditors. Such an automatic operation is at least not a disadvantage. It sets up a kind of double entry — the stock ledger balances with the capital stock account. When we come to consider the classification of shares, we shall see some interesting situations in which, after part of the shares have been redeemed and canceled, the aggregate par of all the *existing* shares does not equal the capital stock. Still, the redeemed shares have been

issued; and shares once issued can never be unissued, so to speak, except through appropriate proceedings for the reduction of capital stock with the consent of the State.

Though it may commonly be the case that the aggregate of the par of the issued shares sets the measure of the capital stock (and we have fallen into the error of speaking of it as universal) it need not necessarily be so. Delaware (and perhaps other States) provides for a transfer from surplus to capital without change in the shares, and, presumably, as to creditors the fund becomes by this amount greater than the total par, so that the par has no other significance than of being the value which must be received on issue.

STATED MEASURE OF THE SIZE OF THE FUND WITH NO PAR SHARES

No automatic device establishing the measure of the minimum capital stock fund attaches to no par value stock. What then shall the measure be?

Statutes give directors authority to fix the consideration on which par shares shall be issued. If the consideration is cash, the amount received (and, in the case of shares not full paid, to be received) would be the created, or issued, capital stock, except for one thing. We have the problem of paid-in surplus.

A corporation issuing 20,000 shares, of the par value of $50 a share, for $50 a share, would have a capital stock of $1,000,000. If the same corporation had issued all the same shares for $75 a share, the capital stock would still be $1,000,000, and the $500,000 additional received would be paid-in surplus.

Can a corporation issuing *no par* shares create a paid-in surplus?

Some of the statutes authorizing no par shares provide, in effect, that whatever the corporation receives on their issuance shall be the capital stock. It would seem dangerous for those conducting corporate affairs to interpret such a statute as permitting a paid-in surplus in the absence of judicial interpretation allowing it. Though the legislature may not have intended to prohibit such a surplus, the language seems not to permit one.

Yet there seems to be no reason, in the nature of a corporation, why a paid-in surplus ought not to be created on the issuance of no par shares. If the stockholders agree that, of the $75 they pay in for a share, $50 shall be a contribution to capital stock,

and $25 a contribution to surplus, we still have the creditors to consider. The resulting situation, however, puts creditors in exactly the same position they are in when $50 par value shares are issued for $75 a share.

Some statutes expressly provide for the creation of a surplus on the issuance of no par shares. The Delaware statute reads: "If the Board of Directors shall not have determined *** at the time of issue of any shares of the capital stock of the corporation issued for cash *** what part of the consideration for such shares shall be capital, the capital of the corporation shall be *** the amount of consideration for such shares without par value." [1]

If "determined *** at the time of issue *** what part of the consideration *** shall be capital" means that a man who subscribes for stock shall know that he is undertaking to contribute so much to capital and so much to surplus, then such a provision seems entirely proper. New Jersey says: "The board of directors shall have the power within thirty days after the issuance of any shares without nominal or par value to determine what part of the consideration for such shares shall be capital and what part, if any, of such consideration shall be surplus." This seems undesirable. Those who are providing economist's capital may have their own ideas of business expediency as between establishing capital stock for the advantage it should give the corporation in procuring credit, and establishing paid-in surplus for the advantage they may gain through enabling the corporation to suffer loss without impairing capital. Giving the directors a *locus penitentiae* seems to have no social advantage sufficient to overcome the social desirability of giving stockholders an opportunity to exercise their own judgment.

Delaware gives the directors sixty days within which to allocate to capital and surplus the consideration received for no par shares issued for property. This seems less objectionable. Without a hampering statutory requirement of a meeting there is no way to give existing stockholders control. It seems desirable that the statute should deal explicitly with paid-in surplus in no par shares, and that it should require directors offering them to state what part of the proceeds, if any, is to be allocated to paid-in surplus.

[1] General Corporation Law, Delaware, Sec. 14; Rev. Code, c, 65, Sec. 14, as amended by Laws of 1929, c, 135, Sec. 6; John S. Parker, *Corporation Manual, 1935*, p. 261. United States Corporation Co., New York.

NO PAR SHARES FOR PROPERTY

What shall the capital stock measure be when no par shares are issued for property? A representative provision reads that the stock may be issued "for such consideration as may be fixed by the board of directors." When the directors of a taxicab company issue one hundred shares of no par stock for a consideration of ten taxicabs they can hardly state capital stock, which is measure of value, in those terms. Of course they will have to translate the value, ten taxicabs, into the terms of money, and state the capital stock addition. Under a subsequent topic we will discuss this matter further.

RELATIONSHIP OF STOCKHOLDERS TO EACH OTHER

Has the man who, for a property consideration, acquires an interest in the enterprise any duty to give a value equal to the value he receives? Michigan says: "Shares for which the consideration has been paid or delivered in *good faith* shall be deemed full paid." On the principle of *inclusio unius exclusio alterius*, if he deals in bad faith he will not have full paid and non-assessable shares; and the consequence ought to follow that he would be liable for values sufficient to bring his contribution up to his equitable share. We have seen that this is: to furnish a value equal to the value of the shares received so that the value of the shares is not diminished by the new issuance.

Absence of an explicit provision for good faith in other statutes ought not, and presumably will not, result in different consequences. Equity requires good faith in all dealings. But good faith to whom? Suppose a man makes an offer to the directors to sell his property to the corporation for 1000 shares of its no par value stock, which has a market price, representing a fair value, of $100 a share. He tells the directors that the property is worth $50,000; nevertheless, through some influence, he induces them to issue shares worth $100,000 for it.

He is not in bad faith to the directors, but to the stockholders. He has conspired with the agent to defraud the principal. Though he has no duty to the stockholder group principal to give it an equality of value, nevertheless, if he does not, he must make his bargain honestly as to them, without conspiracy or fraudulent representation. On general principles a representation of value

would not be fraudulent. Here we have no statutory requirement of a contribution equal to par. The *pari delictu* principle seems to disappear, and with it all the doctrine of undoing the transaction for failure of lawfulness. We have left only the doctrine of bad faith, on which, presumably, the stockholders have a right to elect to undo the transaction, if it can be undone, or to demand damages; and if the transaction cannot be undone, to demand damages.

STOCKHOLDERS IN RELATION TO DIRECTORS

Since the agent always owes a duty of good faith and diligence, he must respond to his principal in damages for failure in that duty. So the director-agents should be held liable to the stockholder group principal for failure of either good faith or diligence in making a bargain which is fair to the stockholders.

Any duties of stockholders to creditors are correlative of rights of creditors against stockholders. So we will discuss this aspect of no par stock under the topic of creditors' rights.

CREDITORS' RIGHTS IN RELATION TO THE CORPORATE GROUP

Here we can happily be both brief and simple. Whether stock be par or no par, creditors have a right to have the entire corporate assets applied to the satisfaction of their claims. Such application of the total corporate funds of course carries with it that part of the fund which comprises the corporate capital stock.

CREDITORS' RIGHTS IN RELATION TO INDIVIDUAL MEMBERS OF THE STOCKHOLDER GROUP

Our topic heading oversimplifies the problem. A case of creditors' rights may include individuals who have been members, but are so no longer. Of those who are now members some may stand in a different relationship to the creditor from that of others. We have our series of problems. Any rights of a creditor arise out of a transaction of the issuance of stock, which takes place at a moment of time. We have the creditor in relation to the man to whom the stock is issued, and this in the twofold aspect: while he is still a stockholder, and after he has assigned

his shares. We have the creditor in relation to the stockholder who has taken the shares by assignment. We have the rights of the creditor in relation to those who were members of the group at the time of the transaction, and in relation to those who came into the group subsequently. There is no reason to believe that whether stock is par value or no par changes the effect on the rights of the creditor of these variations in relationships.

In the case of par stock we have seen the statutory duty to the stockholder group to contribute a value equal to the par of the issued stock, the consequences of a right to have the transaction set aside, and, in some few jurisdictions, to require the contribution of the value that ought to have been contributed. Since these are rights of the group they are assets of the corporation for the creditor to reach. Further, we have seen the direct statutory duty to creditors in the case of par stock.

Will the man who has not contributed his equitable pro rata to the fund in the case of no par stock stand in any better position than the man who has not contributed the statutorily required amount in the case of par stock? Let us consider some of the statutory provisions for no par shares.

New Jersey says they may be issued "for such consideration as may be fixed by the Board of Directors," and that "shares issued as permitted by this act shall be deemed full paid and non-assessable." Delaware provides that they "may be issued for such consideration as may be fixed from time to time by the board of directors," and that "any and all shares without par value so issued for which the consideration so fixed has been paid or delivered shall be deemed full paid stock." New York says the shares may be issued "for such consideration as may be the fair market value of such shares, and, in the absence of fraud in the transaction the judgment of the board of directors shall be conclusive."

These are samples of statutory requirements on the issuance of no par stock. Nothing in them indicates that a man dealing at arm's length, and without fraud, may not get as good a bargain as he can, even much more than his property is worth. New York gives the clue to the situation. He may, in the absence of fraud in the transaction. If he makes fraudulent representations, or conspires with the directors, and he has not given such consideration as is the fair market value of the shares, they have not been issued in accordance with the requirements of the statute,

any more than if par stock had been issued for less than par. All this is only the equitable principle, which would be applied irrespective of statute.

Since the equitable right is a right of the group, and therefore an asset of the enterprise, the problem of antecedent and subsequent creditor does not arise.

The New York phrase of "fair market value" presumably means only that the market price may be taken as prima facie evidence of value, and that if market conditions are such that the price is not fair, the market price would not be conclusive.

So it would appear that the man who has no par stock issued to him is not put on his inquiry as to the value of the shares — and this whether creditors or fellow stockholders make demands on him. If he can bargain with the directors at a cash price of \$50, or a property value of \$50, for a share which has a value of \$100, he may do so, as long as the transaction is not tainted with fraud. Here the preëmptive rights of the stockholders come in on the cash transaction to give them their protection, if they have not bargained the rights away by charter provision. In the property transaction they have no such protection. Presumably a gross case of discrepancy in the exchanged values would not take place without fraud. Still, even in a situation of substantial discrepancy, existing fraud might be difficult or impossible to prove.

CREDITORS IN RELATION TO DIRECTORS

Directors have the responsibility for fixing the consideration on which no par shares may be issued. Their responsibility, however, is to stockholders, and not to creditors. No par shares contain nothing in the nature of a representation or "holding out" to creditors. As to existing creditors every dollar of value acquired by the corporation on the issuance of stock is a dollar they had not bargained for. It is a windfall. For subsequent creditors there must be the stated measure of the corporate capital stock, which we have already discussed for no par shares. If the measure is not as large as it ought to be, and if the directors do not perform their duty to see that this measure is filled at the time the shares are issued, they are responsible to the stockholder group, and, again, the responsibility is an asset of the enterprise for creditors to reach.

On this basis we would seem to have something more than the

responsibility of directors for a correct financial statement, i.e., that the assets are set up in the accounts at a proper value. For this liability of directors, the creditor would have to show that he saw the statement and relied on it in extending the credit.

EXAMPLE OF RIGHTS

Incorporators, three in number, agree to take a total of ten shares of no par stock. On organization the directors fix the amount to be paid in on the subscribed stock at $100 a share. The incorporators unanimously authorize the directors to accept an offer of a manufacturer of five new motor trucks worth $2000 each for 200 shares of the no par value stock. This is at the value rate of only $50 a share.

The incorporators pay in to the corporation $1000 in cash and the directors issue to them ten shares of no par value stock. The manufacturer delivers the trucks to the corporation, the directors issue to him the 200 shares, and set up the value of the trucks in the accounts at $10,000. The capital stock of the corporation is $11,000, and the corporate statement is:

Assets

Cash	$ 1,000
Equipment	10,000
	$11,000

Liabilities

Capital stock, 210 shares of no par value	$11,000

There is no liability of stockholders directly to creditors. The manufacturer who sold the trucks made his bargain in good faith, and has no further responsibility. The other stockholders have exonerated the directors by approving the transaction in advance. If they had not so approved it they might have ratified it, at least by a unanimous vote, because there is nothing unlawful about the bargain, as there would be on the issuance of 200 shares of the par value of $100 a share.

If the stockholders had not approved the transaction they could hold the directors. Subsequent creditors could enforce this right against the directors. If the directors had set the value of the trucks up in the accounts at $20,000, subsequent creditors

relying on the statement of capital stock $21,000 could hold the directors, as also, presumably, subsequent relying subscribers to the stock, and, perhaps, subsequent relying assignees of the shares. All of this, and any antecedent matter of this chapter, is presented with a caveat that we are not attempting to state or prognosticate the law of any jurisdiction, but are simply endeavoring to present a theory of no par stock.

PREËMPTIVE RIGHTS

Failure of preëmptive rights to afford protection to stockholders, in the case of shares issued for property, has been commented upon. In that case we have seen that the requirement of a value equal to par gives them so much of assurance on the issuance of par value shares, a safeguard which disappears with shares of no par value.

Issuance of stock for property, when there are no preëmptive rights, presents a serious problem. We have remarked Berle's comment on the way in which their denial came into the law. We have these choices:

(1) To continue their denial for the advantage of its expediency in business; or

(2) To restore them as an essential safeguard of the corporate concept.

Let us assume that their restoration would be practically prohibitive of the acquisition of property by the issuance of shares for it. Is such a prohibition too horrible to contemplate?

If, in our economic affairs, we are to continue the private ownership of property which goes under the misnomer of capitalism, we ought constantly to strive for principles which represent an endeavor for justice. It seems probable that requiring all contributed corporate funds to be paid in cash would reduce fraud. By bringing judgment to a sharp realization of cash values, it would perhaps reduce error. Very likely it would slow down extensions of entrepreneurial activity. Though such a retardation might also reduce the economic gains of society, it might even not do this.

Wreckage, both constant and periodical, resulting from speculative activity, goes at least a long way towards offsetting the social gains of such activity, even if we confine our idea of social

advantage to economic welfare. And it may be we would do well constantly to challenge our economic activity from other viewpoints than that of production, or even of the production and distribution of wealth. The physical world, in which men live, and men's own biological instincts, confront them with constant risks. In our endeavors to escape from them we are almost as constantly creating risks in the economic organization of society. If we consider prohibiting the issuance of stock for anything but cash, we might next consider prohibiting the creation of funded debt for anything but cash.

CHAPTER XIII

Classification of Shares

Every commitment of (economist's) capital to enterprise contains the elements of risk, income, and control. And this is so whether the commitment is that of an owner of (or in) the business, or that of a creditor with whom he contracts for capital. Both supply capital, and we may speak of both as committing it. To differentiate the rights and liabilities of an owner from those of a creditor, we may speak of an owner as *contributing* capital. We have no correlative word for the commitment of a creditor — we can only say that he makes it on the terms of a creditor's contract.

INDIVIDUAL OWNERSHIP IN RELATION TO RISK, INCOME, AND CONTROL

When one man alone engages in enterprise, his rights are to have all the profits, and his liabilities are to bear all the losses until all his assets are exhausted. Even then he remains liable, so that if, by his earnings, by gift, or by inheritance, he acquires new assets, his creditors can cause them to be applied towards the satisfaction of their claims. And this liability continues unless and until he clears himself through bankruptcy proceedings.

Speaking broadly there are no distinctions, other than those expressly contracted for, among the claims of those to whom he is liable, except for the priority of taxes and, generally by statute, for wages of employees. Though, for his own information, he may keep an account with himself of his business, separate from the other accounts, this is a game of solitaire he plays for his own satisfaction — or to meet the income tax inquisition of government. As far as his liabilities are concerned, there is no distinction between capital he has committed to his business and his other wealth. Since only one enterpriser, or owner, contributes capital, of course there can be no contract among owners for or in relation to its contribution. But he can make as many contracts

as he pleases and can induce others to enter into for the commitment of capital on creditor contracts, and in the contracts can vary widely the elements of risk, income, and control.

Let us consider these elements first in connection with the capital contribution of the owner. He has, we know, all the risk up to the exhaustion of his entire wealth (except for those small items which may be exempt from seizure by his creditors). Upon such exhaustion of his wealth he may free himself from further risk by bankruptcy. Beyond that point his creditors bear the risk. He has all the income from his enterprise, and the entire control of it, except so much of each element as he may contract away to creditors.

He may separate from control that constantly active part of it which is management. That is, he may appoint an agent to conduct the business. On such a division, however, the part he retains enables him at any time to resume the management himself, or to appoint another agent. If the owner employed his agent under an agreement for a period of time, the owner, on revoking the agent's authority, becomes liable for breach of contract, at least unless he continues to pay the agreed compensation. Nevertheless, the control of the owner enables him to dictate the management. Hereafter, when we use the word "control," the context will show whether we mean the entire control including management, or control as separated and distinct from management.

CREDITOR'S CONTINGENT CONTROL

It was indicated at the end of the preceding paragraph that the owner might contract away to creditors part of his control. If he borrows money without giving security, he has given his creditor a right to interfere with the operation of the enterprise to the extent that if the owner does not voluntarily pay his debt, the creditor, through judgment and levy of execution, can take away from the enterprise enough of its assets to satisfy his claim. If the owner gives the security of a mortgage, the creditor can, through foreclosure, take the mortgaged assets out of the business. By force of the law, without express contract, the creditor acquires a variety of other means of interfering with the owner's control. He may have the entire control taken away from the owner through an equity receivership, or through bankruptcy, under conditions giving rise to the right to exercise either of these remedies.

credit so that A may sell goods to C on credit; or that A obtains credit from a bank so that he may extend credit to his customer? An extension of credit does not of itself increase wealth or diminish risk. Wealth and risk are all there — no more, no less of either, except as the credit process may facilitate the production of wealth, and may itself create an economic hazard. But does not the hazard outweigh the facilitation? This parenthetical paragraph can only suggest, not state, an idea. We are dealing with economic organization as it exists.

PARTNER OWNERSHIP IN RELATION TO RISK, INCOME, AND CONTROL

Ordinarily, in the case of individual ownership of business, we find no contract for the contribution of owner's capital. Creditors might make their commitment on the basis of a contract that the owner should contribute an additional amount. Such an agreement would be one relating to risk. In the opinion of the creditor the risks of the enterprise would be reduced by the increase of owner's capital; and reduction of risk in the enterprise would reduce the total risk of the owner's solvency. However, the prospective creditor does not generally contract for it. He simply declines to make his commitment under the existing conditions. He does contract in relation to capital which has been committed, whether by the owner or by other creditors, when he takes security.

When we come to partnership enterprise, however, we find the partners contracting with each other as to the terms on which, as among themselves, they make their capital contributions; the proportions in which they will share risk, and income, and control. Since the partnership principle that each partner is a general agent of the group limits the value of making an agreement among the partners in relation to control, they are likely not to contract with each other in the matter. In connection with their contributions, they contract for the proportions in which they will share income, and, as among themselves, the proportions in which they will bear losses, and they make their agreement as to these two elements with the third element, control, as determined by the law in the absence of contract, or as they may — perhaps, as far as they can — make it a matter of agreement.

Now that we have come to group enterprise we find the risk of creditors directly affected by the capital commitment. The prin-

ciple that creditors of the members of the partnership group, in non-partnership transactions, have a priority as to individual assets, but conversely are subordinate to firm creditors as to partnership assets, affects the risk of those who extend credit to the firm.

In both individual and partnership creditor capital commitments we find the law also limiting the field of contract in relation to income. Usury statutes commonly restrict the rate of interest that may be stipulated, frequently to an amount not in excess of six per cent. Though the creditor may accept any risk he is willing to assume, he will, in practice, limit the risk he contracts for to one consistent with the limitation of income which he can receive.

CORPORATE ENTERPRISE IN RELATION TO RISK, INCOME, AND CONTROL

For our immediate purpose we are interested only in contracts for the commitment of capital among owners who are contributing it, and are saying only enough to sketch the idea that these agreements relate to the elements of risk, income, and control. We will not delay to present illustrations from statutory limited liability partnerships or associations under declarations of trust, but will proceed to consider these elements in connection with the statutory corporate group.

At once we see a limitation by law of the field of contract in relation to the element of control. In the corporate form, management must be divided from control, at least in form; and even in extreme cases, in which no wide space appears between the two parts, the line of cleavage is always visible. Let us consider a specific instance, that of a corporation of a State in which the statutory requirements of the minimum number of directors is three. Let three men own all the stock, be the three directors, and one the president, one the treasurer, and one the secretary of the corporation. Actually the owners manage the business. Yet they must in their transactions mark a distinction between their functioning as owners and as managing agents.

Though the situation is common, it is extreme; and even so, it has implicit in it the potential separation of function without the owners acting as such to effect it. Any one of the owners may sell some of his shares, and by the addition of the member to the ownership group create two groups, one of owners

and one of managers. The membership of the owner group is no longer identical with the membership of the management group. All contracts among the stockholder owners in relation to control must be made within this limitation of the law, that the management functions must be explicitly sorted out, exercised, and expressed separately from functions of ownership as such. Though this legal requirement restricts contracts in relation to management, it does not much, if at all, interfere with contract in relation to control as apart from management.

Within the limitations indicated the stockholder owner group is free to make such agreement among themselves as they desire in relation to risk, income, and control. Outside of the principles governing the creation of the capital stock fund, creditors are not concerned with the relationships of stockholders to each other. They have a right to have the fund maintained to the extent that the stockholders and their director-agents shall not voluntarily do anything, without the consent of the State, to diminish it. They have a right to exhaust the corporate assets, which will result in exhausting the fund, for the satisfaction of their claims. These rights of the creditors are the correlative liabilities of the stockholders.

Organizers of corporations have not exhausted the possibilities of the field of contract in stockholder relations with each other, but have explored them extensively. Certain types of stockholder relationships have become familiar enough to be designated by generally recognized names.

IN THE ABSENCE OF SPECIAL STIPULATION ONE SHARE OF STOCK IS IN ALL RESPECTS LIKE EVERY OTHER

We begin with the general principle that in the absence of special stipulation one share of stock is in all respects like every other share. Dividing the capital stock of a corporation into equal shares is simply a device to make ownership fungible. One share represents the minimum interest a man must have in the enterprise in order to become a member of the corporate group. Since in corporate enterprise management is separated from control, the stockholder as such makes no contribution of services to the enterprise. His interest, therefore, is in proportion to his contribution of capital.

The proportions may be seen from the viewpoint of no par value

shares as the relationships of the values existing at the time a new contribution is made to the new value contributed; or may be seen from the viewpoint of par value shares, which require a minimum contribution even though the values per share existing at the time the new contribution is made should be less than the value per share of the new contribution. In either case it is the duty of the directors to see that the required proportions of contribution, whether those of par or no par shares, are maintained on the admission of new members to the group by the corporate receipt of new capital, or on new contributions made by existing members changing the owner interest relationships.

Since, in the absence of express stipulation to the contrary, one share of stock represents the same rights and liabilities as every other share, the division of the total rights and liabilities of ownership into these equal shares facilitates the process of additional capital contributions to the enterprise whether by new or old members, and the transfer of rights in the enterprise. The shares are an accounting device which increases the flexibility of the corporate group.

CONTRACTUAL VARIATION

By express stipulation, however, the rights of stockholders with respect to each other may be varied. Such variation is essentially contractual. Incorporators signing the certificate of incorporation are the nucleus of the corporate group. They are the group until new members come in. The certificate expresses the terms on which they will admit new members, if they admit any. Each time the corporation offers shares to any except the existing stockholders, the charter presents all the terms of the offer except price. It is an instrument of public record, of which new stockholders are bound to take notice, as far as their rights with regard to members of the corporate group are concerned. Some corporation statutes require the essential terms of this contract of stockholders among themselves — the capital stock clauses of the charter — to be printed on the stock certificates issued. But such printing is merely evidence of the contract which has already been made by the subscription.

CLASSIFICATION OF SHARES

If there is any variation of the rights of stockholders among themselves, so that the rights of one stockholder are not just like

the rights of every other stockholder, except as the proportionate interests vary with the number of shares held, the certificate of incorporation expresses the variation by a classification of shares. Such a classification divides the group into sub-groups. Bringing along our fundamental idea that all contracts for the commitment of capital to enterprise involve the elements of risk, income, and control, let us restate the stockholder's contract of commitment. It is understood that in this connection we are using the word "contract" loosely to include statutory requirements.

With respect to risk, the stockholder's commitment is an owner's contribution. It differs from individual and partnership commitments in that the individual owner or partner must lose all the wealth he has, whether committed to the enterprise or not, before a creditor suffers loss. The stockholder loses only that which must be committed under the principles of the capital stock fund. But this duty of stockholders to creditors does not prevent the members of the corporate group from agreeing that as among themselves they will not share losses equally, but will bear them in accordance with their agreement expressed in the classification of shares.

As long as the capital stock fund is unimpaired, the stockholders may have all of the income or profit of the enterprise paid to them, and will have it paid if the directors so determine. But the formulation of the corporate group may provide variation in the rights of stockholders among themselves to income or profits.

Since the members of the corporate group must divide management from the whole of control, and give management to a directing board, they have left only control minus management to contract about among themselves. Control does not consist solely in the election of management. Some major matters of policy still rest in the stockholders — as increasing the authorized amount of capital stock or number of shares, or changing the purpose of the business, or reducing the capital stock, or mortgaging or selling all or substantially all the assets of the enterprise. As already indicated, these are matters affecting the rights of stockholders among themselves. Without entering into the question of how far the stockholders may go in agreeing among themselves for control, i.e., the extent to which they can limit management, we will remark that generally they may contract to a substantial extent in relation to it. Such contracts are more likely to be made on incorporating an essentially partnership enterprise than in forming a larger group.

RISK, INCOME, CONTROL ARE CORRELATIVE AND INTERRELATED

Risk and income are correlative matters, as also are risk and control. Our classification does not mean that in capital commitment agreements the clauses can be sorted out and classified; as, this clause relates to risk alone, this to income alone, and this to control alone. A provision may have a bearing on all three.

For convenience in accounting a man who commits capital to enterprise makes a division between principal and income. If he contributes $1000 to the capital of a corporation, however, receives no dividends for ten years, and at the end of that time has $1000 returned to him in liquidation of the business, he has suffered an even greater loss than if he had received $60 in dividends each year for ten years and then in liquidation received only $400. In both cases the same aggregate has been returned to him, but in the second case he has had some of it returned earlier, and therefore it has been of greater worth to him. This is not the place to go into the theory of principal and income. We need only to keep in mind that they are not really severable things, however convenient it is for accounting purposes to treat them as if they were.

Since we find the convenient concepts of principal and income developed, and capital commitment contracts are made in terms of these concepts, we will consider the customary agreements of this kind in the terms in which they are made.

CLASSIFICATION OF CAPITAL STOCK INTO PREFERRED AND COMMON STOCK

Most frequent of the classification of shares in the stock of corporations is that into preferred and common. It may be helpful to consider the phrase "common stock." If a corporation has not classified its shares, they represent in the aggregate the totality of the rights of the stockholders in the enterprise, and each share its pro rata division of that totality of rights. Sometimes the total of the contributions of stockholders, when all are on an equality, share for share, is spoken of as the common capital stock. If some stockholders agree that other stockholders shall have rights which differ in certain specifically stated ways from those they would have if all shares were alike, it may be considered that out of the common capital stock a special kind of stock has been created,

which by reason of the nature of certain rights contracted for, in consideration of the foregoing of other rights, is called preferred stock, leaving the rest to be designated by the term "common stock."

Since common stock represents the residuum of all the rights not specifically contracted away, we can arrive at the rights of this residual class of stock only by considering the rights which are specifically given to another class, or other classes, of stock. Going on, therefore, with the most frequent classification of stock into preferred and common, we will consider the rights which, if expressly stated, are given to preferred stock. One should always keep in mind that the term "preferred stock" has no meaning in itself, but only with respect to the specific matters in which it has a preference.

PREFERRED AS TO ASSETS

A usual preference is based in practice on marking a distinction between principal and income, and provides that the preferred stockholder shall in any partial or total liquidation have his principal returned to him before any return of principal is made to common, or other class, of stockholders. The word "principal" is used as representing the general idea. The actual undertaking is to return a specified sum, which may or may not exactly coincide with the amount committed. It does not happen in practice that the amount to be returned is less than the amount contributed. The idea of a return of principal is followed to that extent. But for reasons which will be indicated later, it often happens that the amount to be returned is somewhat greater than the amount contributed. Though, as said, in practice the preference is created on the basis of making a distinction between accountant's capital and income, on principle presumably it might go to any extent, as an agreement that in liquidation the preferred stockholder should receive $1000 for each $100 committed. A form of capital stock clause providing a preference as to assets might be:

"Upon the dissolution or liquidation of the corporation whether voluntary or involuntary, or on any distribution of assets by way of return of capital, the holders of Preferred stock shall be entitled to be paid One hundred and ten ($110) Dollars for each share of Preferred stock held by them, plus an amount equal to all accumulated and accrued preferred dividends on such stock before

any amount shall be paid to the holders of Common stock. After such payments all further distribution of assets of such kind shall be made to holders of Common stock."

The provision about further distributions is needed because of the general principle that all shares are on an equality except as expressly stipulated to the contrary. For example, assume that the total number of shares of stock is 20,000 divided into 10,000 shares of preferred stock and 10,000 shares of common stock, and that on dissolution of the corporation, and liquidation of its assets, the amount to be distributed to stockholders is $3,000,000. If the preferred stockholders are to receive no more than $110 a share, they would be entitled to an aggregate of $1,100,000 and the common stockholders to an aggregate of $1,900,000, or $190 a share. But if the preference is not coupled with a limitation, and the principle of equality of shares applies, after the preferred stockholders receive $110 a share the common shares would be entitled to receive $110 a share. Then the balance of $800,000 would be divided between the two classes of stock, $400,000 to each class, with the result that the preferred shares would receive actually $150 a share and the common shareholders the same amount, instead of the $190 a share they would receive with the expressed limitation on the preferred stockholders. Though in a given jurisdiction it might be decided that such a result was not the intent of the provision without the expressed restriction — decided, that is, that the restriction was implied — still such a decision would be contrary to the principle of equality.

If those in control of the corporate affairs were cognizant of the possibility that the preferred might share equally with the common in the excess above $110 a share for both preferred and common, perhaps they could prevent this result, if they wished. Presumably the amount of net worth above $100 a share for both preferred and common is surplus. If the surplus were of a kind out of which dividends could be declared, the directors could pay it out either in cash or as a stock dividend to the common stockholders before dissolution; so there would be nothing in excess of $110 a share distributable to preferred stockholders.

PREFERRED AS TO DIVIDENDS

Generally, preferred and common stockholders bargain on the basis that the preferred stockholder shall have less of the risks of

the enterprise in consideration of accepting limitation in his shares of the profits. The preferred stockholder stipulates for a preference in the distribution of dividends, and the common stockholder stipulates that he shall have all the profits in excess of the preference. The usual preferred stock might as properly be called restricted stock. But the terminology of investment finance is largely adopted on the principle of *nul nisi bonum.* A preferred stock stipulation with respect to dividends might read:

"The owners of Preferred stock shall be entitled to receive cumulative preferred dividends, from the issuance thereof, at the rate of, but not exceeding, seven (7%) per cent per annum on the par value thereof, payable when and as declared by the Board of Directors out of surplus or net earnings of the corporation, in equal instalments quarterly on the first days of January, April, July and October, to owners of record at the close of the twentieth day of the month preceding, before any dividend shall be paid to or set apart for the owners of Common stock."

Deferring for the moment consideration of the word "cumulative," we note that the words "not exceeding" are inserted before the rate. This relates to the same matter as the corresponding limitation on the preference as to assets, i.e., that presumably all shares are alike unless expressly stipulated to the contrary. On this presumption the preferred stock, without this limitation on the dividend, would be participating. It would receive its seven per cent, then the common would have a right to seven per cent, and preferred and common would share equally beyond that. As in the case of the preferences as to assets, it might be that a given jurisdiction would decide that this was not the intent, and imply the limitation; but, again, this would be contrary to the principle of equality. Other matters in connection with the dividend preference will be discussed next in the consideration of the cumulative provision.

CUMULATIVE AND NON-CUMULATIVE DIVIDENDS

Some problems arise in this matter of the limitation of the risk by the stipulation for a preference as to income. If the word "cumulative" had been "non-cumulative" in the stock clause so that it read "shall be entitled to receive non-cumulative preferred dividends at the rate of seven (7%) per cent per annum," what

would the situation be? The clause must be read with its concluding phrase "before any dividend shall be paid to or set apart for the owners of Common stock."

Assume that a corporation, with 10,000 shares of stock, preferred (non-cumulative) as to dividends up to seven dollars a share, and 10,000 shares of common stock, earns available for dividends $100,000 a year. May the directors by failing to declare any dividends on either preferred or common stock for five years accumulate a surplus of $500,000, then pay $70,000 of dividends on the 10,000 preferred shares, and distribute the rest, $430,000, or $43 a share, to the common stockholders?

The situation seems inequitable. The corporation had earnings out of which the directors could have paid dividends on the preferred stock. On the other hand, the preferred stockholders had not stipulated that the common stockholders should not receive so great a benefit. A New Jersey court decided, primarily on the basis of statutory provisions, that if the earnings of a given year are adequate to pay the preferred stock dividend in that year, those earnings may not be used to pay dividends on the common, until the dividend for that year on the preferred has been paid. The court, with the assistance of statute, applied an equitable principle to the contract.[1]

On the other hand, a Federal court has decided that the language of the stock clause before it did not require that the preferred stockholders be satisfied out of the earnings of a given year before earnings of that year may be applied to the payment of dividends on the common stock (though, perchance, the directors might have a *right* so to pay the preferred stockholders).[2] The topic is not nearly as simple as this brief statement indicates. Cases cited here are only two of a whole series. Results depend on the precise wording of statutory and charter provisions. These variants and their judicial interpretation extend beyond the scope of this work.[3]

Such a decision as that of the New Jersey court does not erase the distinction between cumulative and non-cumulative stock. Continue our assumption of a corporation with 10,000 shares pre-

[1] *Day v. U. S. Cast Iron Pipe & Foundry Co.*, 95 N. J. Eq. 389, 123 Atl. 546 (1924).

[2] *Wabash Ry. v. Barclay*, 280 U. S. 197 (1930).

[3] For a discussion see W. H. S. Stevens, "Rights of Non-Cumulative Preferred Stockholders," *Columbia Law Review*, December, 1934, Vol. XXXIV, No. 8, p. 1439.

ferred as to dividends up to seven dollars a share, and 10,000 common shares, and assume that the earnings for five years are:

$ 35,000
140,000
35,000
175,000
35,000
$420,000

Under a cumulative provision the preferred stockholders would have a right to receive an aggregate of $350,000 in dividends for the five years. But under an interpretation of a non-cumulative provision that required earnings of a given year to be applied to the non-cumulative preferred stock before earnings of that year could be paid on common stock, the preferred stockholders, one infers, would not have a right to have the deficits in the odd years made up out of the surpluses of the even years; and they would receive an aggregate of only $245,000, instead of the $350,000 they would have a right to receive if their stock were cumulative.

Presumably a preferred stock stipulation could be made so strong as to require the directors actually to declare the preferred dividend, if the earnings were sufficient to pay it. Such a stipulation would deprive the directors of the exercise of their discretion, and conceivably might jeopardize the business. The customary cumulative preferred stock clause makes no requirement of this kind. In its absence it is still possible, even though earnings must first be applied on preferred stock, for directors to give the common stockholders an advantage over the preferred stockholders.

Suppose capital employed in the business earns at the rate of ten per cent, and though earnings are available to pay the aggregate of $70,000 per annum of cumulative preferred dividends, the directors do not declare these dividends for five years. Then the unpaid preferred dividends are accumulating profits at the rate of ten per cent per annum for the ultimate benefit of the common stockholder. Expressing mathematically the actual loss to the preferred stockholder, the present worth of an annuity of seven dollars a year for five years is greater than the present worth of thirty-five dollars to be paid five years from now.

Other problems arise in connection with the preference as to dividends. Let us assume the preferred dividend stipulation is simply: "The owners of Preferred stock shall be entitled to re-

ceive cumulative preferred dividends at the rate of, but not exceeding, seven per cent per annum on the par value thereof before any dividend shall be paid to or set apart for the owners of the Common stock." Can the directors safely pay any dividend on the common stock during the year until the full seven per cent has already been paid on the preferred stock? For example, may they, at the end of the first quarter year, declare $1.75 a share on the preferred and $1.00 a share on the common stock? Unless the amounts available for dividend payments continue to be sufficient to pay the preferred dividend, the directors may find at the end of the year that they have made a dividend payment to the common stockholders, but the preferred stockholders have not received their full seven per cent for the year. Do the words "at the rate of" authorize less than annual rates for determining the dividend rights of the classes of stock? If the words "at the rate of" do not appear, annual rates seem to be contemplated. Even with their presence it seems dangerous to declare any dividend on the common until the full annual dividend on the preferred has been paid. In the stock clause presented earlier, providing for preferred dividends at the rate of seven per cent per annum payable in quarterly instalments before any dividends shall be paid on the common stock, it would seem that quarterly rates were contemplated, and that the directors might each quarter pay a dividend on the common, if the dividend for that quarter were paid on the preferred.

CONTRACTS RELATING TO RISK, INCOME, AND CONTROL IN CONNECTION WITH TYPES OF INVESTORS AND ECONOMIC CONDITIONS

An enterprise, in carrying part of the economic hazards of society, has the risks of the type of business it carries on, and its particular dangers within that type. For example, we can conceive the risks of cotton textile manufacture, with a subdivision of the risks of cotton sheeting production, and the special further risks of location, management, and financing of the XYZ Cotton Sheeting Corporation. Some men, in the pursuit of such happiness as they hope will arise out of economic welfare, seek it in the direction of certainty through the reduction of risk; others seek it in the assumption of risk with the hope of the larger possible rewards that follow good fortune. Temperament enters into investing,

and ranges all the way from that of the hoarder of gold, who may fondly, but most erroneously, imagine he takes no chances, to that of the gambler, who will hazard all he has on a throw of the dice.

On one side of the investment bargain we have an enterpriser seeking to do business on other people's money, as indeed he must in any business too large for individual ownership; on the other side we have men seeking to free themselves from the labor of managing capital, but varying in temperament through all the range just indicated. The enterpriser endeavors to appeal to more than one of these temperamental reactions, and offers the investment contracts with variations in the amount of risk taken, and the concomitant variations in income and control.

Many of these contracts, as they have been formulated, are based on the idea of limitation in the amount of money return, compensated by limitation of the share of risk in the enterprise. Latterly, events have pressed upon us anew the hazards of money as a device for evidencing command of wealth. We have been somewhat aware of them, and in creditor contracts, as we shall see, have sought to reduce them by what was thought to be an agreement for a commodity, gold. But the acumen of draftsmen, endeavoring to put the investor astride a contractual fence, has enabled the Supreme Court to pull him over on the wrong side. With so many sovereignties debasing and juggling their currencies, the money device subjects the investor to enormous hazards. It well may be that men, in future investing, will endeavor for types of contracts quite different from some of those we are discussing.

CHAPTER XIV

Further Classification of Shares

In the stockholders' agreement as expressed in the certificate of incorporation it is customary to provide that a preferred stock shall be redeemable. A redemption clause might read:

"The Preferred stock may be redeemed as to any part thereof by purchase in the market, or on call for tenders, at less than one hundred and ten ($110) dollars a share and accumulated and accrued dividends, and cancellation of the stock so purchased. If tenders are called for, the notice thereof shall be mailed to the record owners of all of the Preferred stock, addressed to them not less than thirty days before the day stated therein as the last day for receiving tenders, and the stock tendered on or before the said day at the lowest price shall be purchased to the amount to be redeemed, and the purchase shall be on such other terms and conditions as the Board of Directors shall determine.

"The Preferred stock is subject to redemption as a whole or any part at any dividend date at one hundred and ten ($110) dollars a share plus accumulated and accrued dividends. Not less than thirty days notice of redemption shall be mailed to the record owners of the Preferred stock to be redeemed addressed to them at their addresses appearing on the books of the corporation. If less than the entire outstanding amount of Preferred stock is to be so redeemed such redemption shall be by lot or pro rata and on such other terms and conditions as the Board of Directors shall determine. A sum sufficient to redeem the Preferred stock called or purchased for redemption may be deposited in any bank or trust company (which shall be named in the notice) on or before the date fixed for redemption, and after such notice shall have been given and such deposit made no dividend shall accrue after the redemption date on the Preferred shares called for redemption, and the owners thereof shall thereafter have no rights in or against the corporation with respect to such stock so called for redemption."

MAY REDEEM ONLY OUT OF SURPLUS

Such a clause might appropriately state that the redemption should be only out of surplus of the corporation. Though this provision be not expressed, it is implied as inherent in the nature of capital stock. Since the capital stock fund is created for the benefit of creditors, it may not be impaired by the voluntary action of the corporation. This is a statement of general principle, and is subject to the exception of anomalous statutory provisions in a few jurisdictions, which will be considered later.

Query: whether, even if there be a surplus, stock may be redeemed out of any funds which would not be available for distribution as ordinary dividends — as paid-in surplus, or a surplus created by writing up the value of assets, in jurisdiction limiting the payment of dividends to funds arising out of profits. In any event the course of caution would be not to redeem except out of funds available for ordinary dividends. If such funds exist, creditors are not injured by their application to redemption of stock. By dividend declaration they would be lost to creditor security.

THEREFORE THE STATED CAPITAL REMAINS UNCHANGED

What, then, happens to the capital stock fund on a redemption of stock? Nothing whatever. Consider the specific case of a corporation with:

	Assets	
Net worth		$3,100,000
	Liabilities	
Capital stock		
Preferred (10,000 shares of the par value of $100 a share)	$1,000,000	
Common (10,000 shares of the par value of $100 a share)	1,000,000	$2,000,000
Surplus		1,100,000
		$3,100,000

Pursuant to a redemption provision the corporation redeems all the preferred stock at $110. The corporate position becomes:

Assets	
Net worth	$2,000,000
Liabilities	
Capital stock, 10,000 shares	$2,000,000

What has happened to the "par value of $100 a share" of the unredeemed common stock? There is no creation of a paid-in surplus by the corporation. No surplus has been earned. The liability has not become "Capital stock, 10,000 shares of the par value of $100 a share, $1,000,000; surplus $1,000,000." The capital stock fund created for the protection of creditors had become $2,000,000. No voluntary action of the corporation, without the consent of the State in reduction of capital stock proceedings, may rightfully diminish this capital stock. Presumably the corporation can do one of three things: (1) It can amend its certificate of incorporation to provide that its existing shares shall be replaced by two shares of the par value of $100 each; or (2) amend to provide that the par value of its shares shall be $200 a share; or (3) simply let the situation stand as it is with the par value of the shares continuing. We will reserve further discussion until later in this chapter under the topic of "Redemption in Connection with Authorized and Unissued Stock." If the shares are of no par value the problem of the nomenclature of the outstanding certificates does not arise. The capital stock of $2,000,000 created, represented by 10,000 preferred shares and 10,000 common shares of no par value, simply becomes represented by the 10,000 shares of no par value alone.

WHY REDEMPTION PRICE ORDINARILY ABOVE PAR

Customarily the redemption rate is placed at a premium above the issue price in order to give the purchaser some speculative chance. No one could safely pay in the market more than $100 a share for stock redeemable at any time for $100 a share. If the issue price were $100 a share the subscriber would have no opportunity to profit by sale of his shares, even though the condition of the enterprise should substantially improve. To give a market leeway the redemption price is placed higher than the issue price.

REDEMPTION THROUGH PURCHASE

It will be noted that the clause presented provides two processes of redemption, by purchase and by call. Shares merely purchased by a corporation become treasury stock, which the corporation may resell. Redemption implies a permanent reduction in the number of shares. As we have seen, the provisions in

the charter for the number of shares, and their par value, if any, formally contradict the provisions for redemption. Yet the provisions for redemption are there, and can be given effect without injuring the substance of any rights. Since redemption means a reduction in the number of shares, however, a provision for cancellation of shares purchased for redemption marks the distinction between the purchase for redemption and a purchase for treasury stock. Presumably a call for redemption sufficiently indicates the tenor of the transaction. Redemption means cancellation, but purchase alone is not cancellation.

Obviously the purpose of providing for redemption through purchase is to give those who desire to continue stockholders the benefit of seeing the market price sustained through the acquisition by the corporation of the shares of those who are selling in the market. There is no unfairness in the situation. The stockholder who is selling gets the advantage of the corporate bidding. If really free bargaining in the market fixes the price, neither party in the transaction has cause to complain. All stockholders are treated alike to the extent that all have an equal opportunity. Though this method may be provided, it should not be utilized unless a free and fairly active market exists.

REDEMPTION BY CALL

Consider the procedure on redemption by call for tenders. It is an example of a mechanism of group functioning. If it is anticipated that the stock will have an active market the provision for calls for tenders would not ordinarily be inserted. Every stockholder then has his opportunity to make his tender in the market. He does not know that the corporation is to be a bidder, but the market creates an equality. If the stock is not likely to have an active market, however, a provision for a call for tenders creates the conditions of a market for the purposes of the redemption. On the thirty days notice every stockholder has an opportunity to offer to sell his shares to the corporation. The directors will purchase those offered at the lowest prices.

If the directors elect the method of calling by lot the matter is simple enough. Each certificate of stock carries its certificate serial number, and the certificate represents its stated number of shares. With this basis the call for redemption can be prepared easily.

REDEMPTION PRO RATA

A redemption pro rata means a redemption of the stated fraction of the shares of every stockholder. Carried out directly it will in all probability result in the creation of fractional shares which, on the theory of a share being the minimum division of capital stock, should not be recognized for voting purposes or for the payment of dividends. Observance of this principle forces the possessor of the fractional right to buy or sell a fraction in order to gain the benefit of his fractional interest. This is a difficulty to be avoided where reasonably possible. It could be avoided for par value preferred shares on a call, say, to redeem pro rata fifty per cent of $100 par value shares of preferred stock, by amending the certificate of incorporation to provide for preferred stock of the par value of $50 a share, then calling fifty per cent of the stock for redemption, and exchanging $50 par value shares for the unredeemed part.

FURTHER EXAMPLE OF EFFECT ON SURPLUS

Redemption of preferred stock, as we have seen, simply effects a re-division of the total capital stock between the preferred and the common through a disposition of part or all of the surplus for the purpose. Continuing our illustration of a corporation which has outstanding 10,000 shares of preferred stock of the par value of $100 a share redeemable at $110 a share, and 10,000 shares of common stock of the par value of $100 a share, when the condition of the enterprise appears as follows:

	Assets	
Net worth		$3,000,000
	Liabilities	
Capital stock		
Preferred	$1,000,000	
Common	1,000,000	$2,000,000
Surplus		1,000,000
		$3,000,000

The corporation redeems fifty per cent of the preferred stock at $110. The corporate situation then becomes:

Assets

Net worth		$2,450,000

Liabilities

Capital stock		
Preferred	$ 500,000	
Common	1,500,000	$2,000,000
Surplus		450,000
		$2,450,000

Corresponding with the case of the total redemption of preferred set forth earlier, in which the common shares came to have a relation to capital stock of representing $200 a share, the common, on this fifty per cent redemption of preferred, comes to have a like relation of $150 a share.

REDEMPTION IN CONNECTION WITH AUTHORIZED AND UNISSUED STOCK

Let us consider the situation of authorized and unissued shares on a redemption, and assume a corporate situation as follows:

Assets

Net worth		$3,000,000

Liabilities

Capital stock		
Preferred stock, authorized 20,000 shares of the par value of $100 a share, outstanding 10,000 shares	$1,000,000	
Common stock, authorized 20,000 shares of the par value of $100 a share, outstanding 10,000 shares	1,000,000	$2,000,000
Surplus		1,000,000
		$3,000,000

With the corporation in this position fifty per cent of the preferred stock is redeemed. How do the shares of preferred and common stock, both the outstanding and authorized, stand? Assume that the fifty per cent of preferred stock has been redeemed by lot. Then 5000 shares represent $500,000 of preferred stock. Since the certificate of incorporation states the par at $100 a share and the actual par is still $100 a share, presumably the directors would not be violating the statutory requirement by issuing additional preferred shares for $100 a share. If they

do not issue the shares pro rata to stockholders entitled to subscribe, but issue them for property, presumably they are under a duty to all stockholders to obtain an equitable value for them.

But suppose the preferred stock has been redeemed pro rata, no amendment of the certificate of incorporation obtained changing the par from $100 a share to $50 a share, and the 10,000 outstanding shares simply stamped fifty per cent redeemed. Though the actual pro rata of the $500,000 of unredeemed preferred stock to the 10,000 shares outstanding is only $50 a share, the certificate of incorporation still states the par as $100 a share, and presumably the directors would be violating the statutory requirement if they issued shares for a less value than $100 a share.

Consider the situation of the shares of common stock. The redemption of the fifty per cent of the preferred stock out of surplus does not affect the total capital stock of the corporation. It is still $2,000,000. But of this $2,000,000 only $500,000 is now preferred. This leaves $1,500,000 of common stock represented by 10,000 common stock shares. The certificate of incorporation, however, still states the par value at $100 a share, and the directors would not be violating the statutory requirements by issuing additional stock for $100 a share. Nevertheless, presumably they would be responsible to all stockholders for issuing it for less than an equitable price. In so far as the stock is subscribed pro rata by stockholders having a right to subscribe, a price of $100 would be equitable though the value were greater.

Some of the statutes expressly limit the right of redemption to preferred or other special stock; and the redemption of such stock to clear away priorities is the essential purpose of the right. Indeed, even without such express statutory limitation on the right to create redeemable stock, query: whether the nature of a corporation does not require that some class of stock be irredeemable as the repository of all rights not inhering in other classes of stock. The somewhat metaphysical question is sometimes asked as to what would happen, with all shares redeemable at a stated amount, if the corporation accumulated a surplus sufficient to redeem all shares on the stated terms, and the directors elected to redeem, leaving a corporate enterprise with assets and no stockholders. One surmises that irrespective of statute a corporation may not be formed which has inherent in its terms the possibility of the disappearance of a corporate group or the potentiality of such a group.

DEVICE FOR CUTTING OFF THOSE WHO FAIL TO PRESENT CERTIFICATES FOR REDEMPTION

Returning to the preferred stock clause with which we began the consideration of redeemable stock, consider the provision for the deposit of redemption funds and cutting off the rights of holders of certificates of redeemed stock with respect to the stock redeemed. This is one of the regular devices to facilitate group functioning in the conduct of enterprise. The corporate record of stockholders may not represent actual individual situations. As far as the corporation is concerned those whose names appear on the corporate books as holders of shares are the stockholders of the corporation. It not only does not know anyone else as a stockholder, but has no right to recognize anyone else as a stockholder.

But of these names some may represent dead men, whose estates are in process of administration. Others represent men who have sold their stock; but the purchaser has not had the shares transferred into his name. The seller, as the record stockholder, receives the notice of redemption, but may not trouble himself to pass it on to his purchaser. Some stockholders may have disappeared. Others may pay no attention to the notice. Such situations should not interfere with corporate functioning.

Yet a man who has not actually surrendered his certificate and received the redemption money may claim that he is still a stockholder. If the corporation at the time set for redemption has the money ready to pay him, it should not be subjected to further responsibility by the failure of the stockholder, or man entitled to be a stockholder, to act. The corporation should not even be responsible for the continued solvency of the bank in which it deposits funds for redemption. All these situations are taken care of by the express stipulation specifically cutting off all claims.

ANOMALOUS PREFERRED STOCKS

Some statutory provisions create an anomaly in preferred shares and permit them to be used in such a way that their issuance does not really create capital stock. Any deviation from the capital stock concept is unfortunate. Values which may not be voluntarily withdrawn from the enterprise, and which if lost without intent must be replaced before any voluntary withdrawal of values,

should be clearly distinguished from values which may be withdrawn voluntarily. Though the older meaning of "stock" is a fund of any nature (as we still say a "stock" of goods), the word has come to mean in the United States, in connection with corporate enterprise, a fund for the protection of creditors. If used as in the British practice of debenture stock, the qualifying adjective clearly indicates a creditor security, and the use of the word "stock" does no harm. The mind, however, immediately translates such a phrase as "preferred stock" into "preferred capital stock," and capital stock has only the one proper meaning of a fund unlimitedly designated for the protection of creditors. A somewhat interesting example of the older more general meaning of the word "stock" appears in the City of New York, where, in accordance with the provisions of its charter of historical origin, the city issues some of its bonds under the name of corporate stock. Sometimes the draftsmanship of the statutes relating to stock issuance and classification is such that the provisions require careful reading.

Michigan formerly had a provision (appearing in Parker's *Corporation Manual, 1927*) that a corporation may have:

> General or Common stock, and preferred stock with such preferences as it may deem advisable, which preferred stock, if preferred as to principal, shall at no time exceed two thirds of the authorized capital stock, and shall, if preferred as to principal, be redeemed by the corporation at par at a certain time to be fixed by the articles and to be expressed in the certificate therefor. Provided, that such corporation may by a provision clearly expressed in its articles and in the certificate therefor, reserve the right to redeem or retire at a premium any or all of such stock preferred as to principal prior to the time when the same must be redeemed as above provided, and upon reasonable notice to be given to the stockholder in a manner to be fixed by the by laws. None of said preferred stock shall, however, be redeemed or retired at a premium unless at the time of such redemption or retirement the assets of the corporation taken at a fair valuation over and above all the indebtedness, both matured and unmatured, are equal to the outstanding stock, both common and preferred, plus the premium proposed to be paid upon the redemption.

Taken at its face the Michigan clause seems to provide for a creditor security under the name of stock, something that might more appropriately be called debenture stock, indicating the creditor character, rather than preferred stock, which usually would be taken to indicate contributed capital for the creation of a capital stock

fund. Under the Michigan clause apparently the so-called preferred stock is to be redeemed absolutely, and nothing indicates that it would not share equally with creditors after the redemption date. The clause does not show its rights on insolvency of the corporation prior to the redemption date: it does not show whether the preferential "dividends" are in reality interest payable absolutely or not. From the silence of the statute in the matter of dividends one would infer that only the principal is of a creditor nature. One assumes from the language that there is no right to create preferred stock redeemable prior to the expressed maturity date except at a premium. If so redeemable prior to the date set, it may be redeemed only when the redemption would not impair the stock fund represented by the common stock. Since apparently the only capital fund required, after redemption of the preferred, is the amount theretofore represented by the common, the preferred stock is in no sense capital stock, except indeed that dividends may not be paid on it, if such is the case, that would impair the aggregate of a fund equal to the preferred stock and the common stock.

Though creditors are on constructive notice through the certificate of incorporation, the utility of such provisions as those of Michigan seems doubtful. In America the word "stock" in connection with a corporation is generally taken to mean "capital stock," and as such to represent a fund for the protection of creditors. In Great Britain a different usage prevails in connection with the phrase "debenture stock."

Michigan has revised its provision for preferred stock to read as follows:

Whenever any corporation formed or existing under this act shall have issued any preferred or special shares it may, subject to the provisions of its articles, redeem such shares, if subject to redemption, at such time or times, at such price or prices, and otherwise, as shall be stated or expressed in the article. Such corporation may at any time or from time to time purchase such shares in the case of shares subject to redemption, at not exceeding the price or prices at which the same may be redeemed but only from surplus. Such corporation may apply to such redemption an amount out of its capital which shall not be greater than the sum of (1) that part of the consideration received for such shares which shall be capital pursuant to the provisions of section twenty of this act and (2) any amounts by which the capital of the corporation shall have been increased by other transfers from surplus in accordance with the provisions of said section twenty; but no such redemption shall be made out of capital unless the

assets of the corporation remaining after such redemption shall be sufficient to pay any debts of the corporation, the payment of which shall not have been otherwise provided for. The shares so reduced or purchased by the application of capital, and any shares of such corporation surrendered to it on the conversion or exchange thereof into or for other shares of the corporation pursuant to the provisions of the articles, shall have the status of authorized and unissued shares of the class of stock to which such shares belong.[1]

Apparently Michigan has abandoned the idea of turning stock into a creditor security, but not the permission to impair capital stock. No attempt has been made to check any of these provisions with other provisions of the statutes, or to see how the courts may have interpreted them. They are presented simply as illustrations of seeming endeavors to tamper with the capital stock concept.

Delaware provides that:

Whenever any corporation organized under this Chapter shall have issued any preferred or special shares it may, subject to the provisions of the Certificate of Incorporation, (1) redeem all or any part of such shares, if subject to redemption, at any time or times, at such price or prices, and otherwise as shall be stated or expressed in the Certificate of Incorporation or (2) at any time or from time to time purchase all or any part of such shares, but in the case of shares subject to redemption, at not exceeding the price or prices at which the same may be redeemed, or (3) at any time or from time to time, by resolution of the Board of Directors, retire any such shares redeemed or purchased out of surplus. The corporation may apply to such redemption or purchase an amount out of its capital which shall not be greater than the sum of (1) that part of the consideration received for such shares which shall be capital pursuant to the provisions of Section 14 of this Chapter and that part of surplus which shall have been transferred and treated as capital in respect of such shares pursuant to the provisions of said Section and (2) any amounts by which the capital of the corporation shall have been increased by other transfers from surplus in accordance with the provisions of said Section 14, except those transfers, if any, which shall have been made in respect of other preferred or special shares. No such redemption or purchase, however, shall be made out of capital unless the assets of the corporation remaining after such redemption or purchase shall be sufficient to pay any debts of the corporation, the payment of which shall not have been otherwise provided for.

Any such shares so redeemed or purchased by the application of capital

[1] Michigan, Act No. 327, Public Acts, 1931, Sec. 37. Quoted in John S. Parker, *Corporation Manual, 1935.* U. S. Corporation Co., New York.

or otherwise retired pursuant to the provisions of this section shall, upon the filing of the certificate hereinafter in this section provided for, and any shares of the corporation surrendered to it on the conversion or exchange thereof into or for other shares of the corporation pursuant to the provisions of the certificate of incorporation shall, after such conversion or exchange, have the status of authorized and unissued shares of the class of stock to which such shares belong; provided, however, that if the certificate of incorporation prohibits the reissue of such shares, the authorized capital stock of the corporation of the class to which such shares belong shall, upon such redemption, purchase, retirement, conversion or exchange, be deemed to be, and shall, upon the filing and recording of an appropriate certificate, executed as hereinafter provided, be reduced to the extent of the aggregate par value of the shares so redeemed, purchased, retired, converted or exchanged or, if such shares are without par value, to the extent of the total number of such shares.[1]

So for Delaware the bare statement in a certificate of incorporation that stock is redeemable must serve as notice that such "stock" forms no part of the capital stock fund, at least unless the certificate expressly provides to the contrary. The stock, unlike that which may be issued under the former Michigan statutes, has no aspect of a creditor security. The corporation does not promise to pay. But it has no aspect of capital stock as a fund for creditors. To be sure, anyone dealing with a Delaware corporation does so on constructive notice of the situation. But constructive notice and actual notice are often far different things. Life requires action, and in the pressure for action men deal on the assumption that in good faith generally accepted principles are followed. Statutory provisions of this kind savor of the nature of trick or unusual clauses in corporation mortgages. They are quite unnecessary for the effective operation of the group. Here again the fact appears that the corporate concept is still crude. Society has still to consider the unsettled problems, and to reconsider the problems that have been settled in error.

Though the provision that "redeemed" stock shall become authorized and unissued stock is relatively harmless, and can be stipulated against in the charter, it is contrary to the usual intent in redemption of definitely clearing away a preference stock to leave the full income and other rights in the common stock.

[1] Delaware G. C. L., Sec. 18, Rev. Code, C 65, Sec. 15, as amended by L. 1933, C 91, Sec. 4. John S. Parker, *Corporation Manual, 1935*, p. 262.

PARTICIPATING STOCK

On the principle that one share has all the rights of every other share, except as differences are explicit in the capital stock terms, preferred stock, as already indicated, would participate equally with the common, after satisfaction of the preferences, in any liquidation or dividend distribution, unless the right to participate were expressly cut off by the capital stock clauses. The reader should keep in mind here, as elsewhere when the phrase general principle is used, that general does not mean universal, as a principle everywhere acted on, but only one which the rules of the various jurisdictions tend to approach.

If the organizers intend a participation, they take no chance of interpretation, but expressly set it forth. Indeed, the participation desired may not be a participation in full, but only a participation in earnings. It may give the preferred stock a share equal with that of the common stock, after satisfaction of the preference; or it may give less; and it may leave the share of liquidation distributions limited to a stated number of dollars per share. Whatever terms are desired should be clearly stated, even though the elaboration of stock clauses expands them to an amount which the small pica of a printer can hardly encompass within the area of a blanket size stock certificate. Such participations are not confined to stock, but may be given to creditor securities as well.

DEBENTURE STOCK

In Great Britain the term indicates a creditor security. The word is not used in the sense of corporate capital stock, but merely to indicate funds paid in by debenture holder creditors. Also it may be an "inscribed" stock, that is, the ownership of the "shares" entered on the corporate books, represented by "certificates," and transferred in the same manner as capital stock. Any creditor contract may be made in connection with it, even the security of a mortgage. In British practice it is commonly given a floating charge, whereby it acquires the security of a lien on the corporate assets in certain events, as default in payment of interest. It may be, and usually is, like a share of capital stock to the extent that it has no maturity date for principal except in the event of default, but is a "perpetual" debenture. Since it is an unquestionable creditor security, it is

merely mentioned here to point out its differentiation from such anomalies as those authorized by the North Carolina and Michigan statutes. At least one well known American security carries the name — E. I. du Pont de Nemours & Co. six per cent cumulative debenture stock; but the title is a misnomer; it is not a creditor security as the word "debenture" (from *debere*, to owe) implies, but a preferred stock.

SINKING FUNDS FOR REDEMPTION OF STOCK

The nearest approach that can be made to a creditor security and still have a share of capital stock (i.e., that which represents the interest in the corporate enterprise of one who is a member of the corporate group contributing owner's capital to create a capital stock fund) is through a capital stock provision for a sinking fund out of earnings of the enterprise that would otherwise be available for dividends. This might appear in a capital stock stipulation to set aside either a stated amount of net profits, or a percentage of such profits, and apply it to the redemption of preferred stock. Such a provision does not require any payment to stockholders at any time when the capital stock is impaired, but only requires the payment of funds which might otherwise be declared as dividends. The rights of creditors are not violated.

Presumably nothing prohibits making the redemption mandatory, if the condition is fulfilled of the corporation having funds which on principle are distributable to stockholders. Generally distributions to stockholders are left to the reasonable discretion of directors, as being sound business practice; and, at least in the absence of mandatory payment, the law upholds the discretion of the directors; nevertheless, if the corporate group wished to formulate on the basis that the directors must pay dividends when there are corporate earnings available for them, presumably it would be permitted to do so. Mandatory provisions create the risk of requiring the special appropriation of corporate funds at a time when it may endanger the enterprise.

CONVERTIBLE STOCK

In a classification of stock, one class may be given the right, on conditions stated, to convert the shares into stock of another

class. Indeed, there seems to be no reason in principle why the option to convert should not be in the corporation instead of, or as well as, in the stockholder, except that, as a practical matter, men would not be inclined to subscribe for, or to buy and sell in the market, shares subject to the risk of a conversion to their disadvantage.

Usually the right of conversion, when given at all, is of a preferred stock into common stock, or into a junior preferred stock, that is, into a stock with preferences subject to the prior preferences of another preferred stock. Here again there seems to be nothing in principle to prevent a right being given to convert common stock into preferred stock, or a junior preferred stock into a senior preferred. But in practice such a provision is not made.

Essential elements of a conversion contract are the rate of conversion, and the time limits on the right. The rate might be share for share, or $150 par of preferred for $100 par of common. In the latter case the preferred stockholder would have to have three shares of preferred in order to convert. The three shares of preferred having a par value of $300 would be convertible into two shares of common. The conversion does not affect the capital stock of the corporation. That has been created and is the fund for creditors. But it may effect the same dislocation of aggregate par value of shares in relation to the aggregate capital stock that we saw in connection with redemption provisions. Query: whether a conversion rate could be made of, say, $100 par of preferred into $200 par of common. Presumably not, in the face of the statutory requirements that $100 in value should be received for each $100 in par issued.

A conversion privilege may be given which may be exercised without limitation of time, or one which may be exercised only before a certain date, or only after a stated date, or only between stated dates.

Conversion agreements tend to confuse the corporate situation, and to make more difficult an estimate of the value of a common stock, the number of shares of which may be increased by conversion. Consider a concrete situation, a corporation with outstanding 100,000 shares of six per cent preferred stock convertible into common stock at $125 par of the preferred for $100 par of the common, and outstanding 100,000 shares of common stock. The corporation is earning $10 a share on the common stock.

The preferred stock is selling at $100 a share and the common at $120 a share. At these prices there is no market profit in converting: five shares of preferred would cost $500 and could be converted into only four shares of common which have a market value of only $480.

Still, prices are approaching a conversion point; and the common stockholder in estimating the worth of his shares must consider the possibility of conversion taking place. Since the corporation is paying six per cent on the preferred, and earning ten per cent on the common, and the number of shares of each is equal, if the earnings remain the same and all the preferred should be converted, the earnings on the common would drop from ten per cent on the common to eight per cent. Convertibility of the preferred constantly overhangs the market of the common. This is quite a different matter from an amount of authorized and unissued shares of common stock. In that situation, if additional common shares are offered for cash the common stockholder's subscription rights at par would give him the corporate values; and if the shares are issued for property the directors must procure an equitable value for them, which presumably would be $120 a share, and this would not dilute the common stockholders' values.

Nevertheless, the possibility of having a conversion agreement may be desirable. It is the simplest way in which to afford the protection of a preferred position as to income and assets, with a limitation of income (and, in liquidation, of assets as well), as long as the preferred position is maintained, and at the same time give an opportunity to gain advantage from an improved position of the enterprise. If those who are promoting a corporate business wish to make this appeal for preferred stock money, the obscuration the agreement brings into corporate affairs seems not so great as to justify forbidding conversion privileges. The privilege is expressed in the stock provisions open for all to see.

If stock or bonds are issued with a conversion privilege, the corporation should have authorized and unissued stock of the class into which the conversion may be made, adequate to provide for the conversion and definitely allocated to that purpose. Otherwise the corporation might find itself in the embarrassing position of being short of its own stock. New York, at least, makes an express provision to cover the situation of bonds convertible into stock when the authorized stock is inadequate. If two-thirds of the stockholders consented to giving the bonds the

conversion privilege, the directors alone are authorized to file a certificate of an increase in capital stock, which otherwise would require action by the stockholders. The stockholders may not in fact have consented to the increase when they authorized the conversion, because then the number of authorized and unissued shares may have been sufficient, but afterwards have been issued. (New York Corporation Law, Section 16.)

WARRANTS

Sometimes stock is issued with warrants, which give an option to purchase further stock on stated terms: as preferred stock issued at $100 a share with warrants for the purchase of no par common shares at $50 a share at any time within three years from the date of the issue of preferred shares with which the warrant is given. The device of warrants was much used during the speculative boom prior to 1929; and warrants were issued with every permissible option contract. Since all stockholders have the right to subscribe pro rata to shares offered with the warrants, there is nothing inequitable in the transaction. But it creates a very obscuring situation. Since the warrants are contracts, and not terms of the stock itself, their provisions are not constantly before all who are interested in the shares. Nothing compels the corporation to state how many are outstanding at any time. They create an overhanging of the market, the extent of which, if ascertainable, is seldom prominently apparent. Probably they will come into fashion again with the next speculative boom.

Though in the opinion of the writer such warrants are deplorable, they give rise to interesting situations of transfer and the stock market. The warrants may be detachable or not. If they are detachable, three quotations may immediately arise: a quotation on the shares with warrants attached, a quotation on the shares with warrants detached, and a quotation on the warrants apart from the shares. Correspondingly provision must be made for transfer of the three types of security.

Neither conversion nor warrant options are peculiar to stock, but may be given with creditor securities as well. Since they are at least as frequently given with stock as with creditor securities it seems desirable to mention them in connection with stock provisions.

SUBSCRIPTION RIGHTS

If the capital stock of a corporation is classified, the matter of subscription rights should be made clear in the stock provisions. Though, as is the case in most corporate matters, one cannot speak definitely of subscription rights except in connection with the statutes and decisions of a particular jurisdiction, yet also as in most matters, there is a line of principle towards which the jurisdictions tend to conform. For such a line of principle it may be said that if a corporation is to issue stock for cash the members of the corporate group have a right to an opportunity to subscribe pro rata to their holdings to the stock, but that the directors may purchase property with stock without giving the existing stockholders an opportunity to subscribe.

On the general principle that, in the absence of express stipulation to the contrary, one share has the same rights as any other share of stock, the holders of all shares of every class would have a right to subscribe pro rata to their share holdings to all shares of every class to be sold for cash. But perhaps some jurisdictions might hold that the principle is not so broad as this, and is only that the holder of each class of shares has a right to an opportunity to maintain his pro rata of his class. In a given jurisdiction one might not find a clear answer to the questions which come to mind.

Careful drafting of stock provisions for classes of stock would do well to make clearly explicit the matter of subscription rights. If a jurisdiction gives stockholders a right to subscribe at par, and even if a higher price is permitted, the right may be a thing of value. People generally are of the impression that if a six per cent cumulative preferred stock is issued, the preferred stockholder is not entitled to more of the corporate values than the six per cent dividend. If it is desired that this should be the case, it should be expressly stated that the preferred stockholder shall not have the right to subscribe to additional shares of either preferred or common. Presumably there is nothing in public policy which requires the preservation to preferred stockholders of subscription rights if they are willing to contract them away. The draftsman of classified capital stock provisions has the problem of making an effective disposition of all rights, and of allocating them in accordance with the desires of those who are causing the corporation to be formed.

VOTING AND NON-VOTING STOCK

In the absence of express stipulation or provision to the contrary each share of stock carries one vote for all purposes. Does public policy require that the right to vote shall not be limited, or even entirely stipulated away, by the stock clauses of the certificates of incorporation? Probably not. Statutes of some jurisdictions expressly authorize a classification of stock into voting and non-voting, and a right so to classify may be implied from the language of the statutes of other jurisdictions. In the absence of statutory authorization, however, one might hesitate to rely on charter stipulation.

But just what is the effect of a charter clause which says that the preferred stock, or Class B stock, or whatever the class may be, shall have no vote? Presumably at least that holders of that class of stock shall have no right to vote for directors. Stockholders of a corporation may, however, have a right to vote on many other matters. Does a clause providing that a class of stockholders shall have no vote mean that they may vote on no matters whatever, unless perchance the statute expressly requires that they shall have a right to vote on certain matters?

For example, the New York Statute (Stock Corporation Law, Section 37, 3, c) places among the requirements for a certificate amending a certificate of incorporation the following provision: "If such certificate alters the preferences of outstanding shares of any class or authorizes shares having preferences which are in any respect superior to the preferences of the outstanding shares of any class having preferences, that they [i.e., the president, or a vice president, and the secretary or an assistant secretary] have also been authorized to execute and file the same by the votes, cast in person or by proxy, of the holders of record of two-thirds of the outstanding shares of each such class *entitled to vote thereon.*" If the stock clauses of the charter say that the preferred stock shall have no vote, do the preferred stockholders have no right to vote on a matter directly affecting their preferences? Presumably the phrase "entitled to vote thereon" means just that, for what other meaning could it have?

Yet if that be so, the situation seems a trap for the unwary. To be sure, the statute also provides (Section 38, 11) that "if the certificate alters the preferential rights of any outstanding shares, any holder of such shares not voting in favor of such

alteration, within twenty days after the meeting at which such alteration was authorized, may object thereto and demand payment for his shares, and thereupon such stockholder or the corporation may have his shares appraised as provided in section twenty-one, all of the provisions of which section shall be applicable." (Section 21 provides for payment of the appraised value to the objecting stockholder.)

Though a stockholder has no vote on any matter to come up at a stockholders meeting, has he a right to attend the meeting, and consequently a right to be given notice of the meeting? If he has a right to notice and attendance, does he have a right to express his opinion and endeavor to influence his fellow stockholders who do have the right to vote? The answer seems uncertain, but on principle should be in the affirmative.

No attempt is made here to do more than suggest questions. Non-voting shares have become much used as one of the means for concentrating control, which will be discussed later. The writer ventures to express his strong antipathy to them as a corporate device.

OTHER CLASSES OF STOCK

Only the more familiar stock provisions have been mentioned. But classification is not restricted to common stock and preferred stock with various preferences and limiting clauses. Most of the field of contract is open to enable apportionment of the risk, income, and control of the enterprise among classes of stockholders. The stock may carry almost any designation, and many have been used, as founders stock, Class A or B stock, and so on. Anyone interested in the classes of stock of a corporation should realize that the name alone conveys no information, or substantially none, and that only the full stock provisions show what the bargain among classes of stockholders is. A classification sometimes used is a Class A stock and a Class B stock, which have as their only difference the provision that one class does not have the right to vote.

CHANGES IN STOCKHOLDER AGREEMENT

Even if denial of a vote to one or more classes of stock continue permissible for the purpose of control, it seems preposterous that changes may be made in the rights of stockholders as against

each other without the consent of all classes of stock affected. Here we touch one of the great fundamental problems of group functioning for enterprise.

When two individuals enter into an agreement, they do not provide that their bargain may be changed without the consent of both. If they did agree that one of the parties should have the right to change the bargain, to any extent he saw fit, without the consent of the other, presumably there would be no contract; because the party who can change the terms of the agreement in respect to any extent he sees fit is, therefore, not bound. And if one is not bound, neither is the other legally. Though the provision for the extent of change might fall short of that, any purported terms of a contract which one party can change without the consent of the other are in effect not terms of agreements for change at all. The man who can change the so-called terms already has all the rights he could express by any so-called change.

Our Federal Supreme Court interpretation of a State grant of a franchise to be a corporation as a contract, with the consequent adoption by the States of their provisions that all charters granted should be subject to amendment, alteration, or repeal at the pleasure of the legislature, created a situation illustrative of the point. Charters granted after the adoption of such a general reservation became in effect not contracts at all, but mere licenses revocable at the will of the licensor.

Consider now the provisions of the corporation statutes for the amendment of charters on the initiation of the corporation. For convenience in discussing the division of capital stock into classes, we have spoken of the classification as an agreement among the stockholders for separating and parceling out among themselves the totality of rights inherent in the ownership of stock. But two very substantial modifications of this idea need to be considered: (1) the statutory right given to the corporation to initiate amendments of the charter, and (2) that such amendments must be consented to by the State. The fact that the statutes indicate in advance the charters and amendments that are consented to, and vest only an administrative authority in the Secretary of State, who must accept, file, and so make effective all charters and amendments in accordance with the statutory provisions which the corporation offers, somewhat obscures the nature of the situation and makes it appear as in fact that the

situation is simply one of agreement among the stockholders, as we have discussed it.

But even as an agreement among members of the corporate group it is one in which the individual stockholder agrees to accept such changes in the terms as stated as a required majority in interest of his fellow members approve. Though his own will may not be actually assenting, he has agreed to accept the will of a majority in interest of those who are his fellow members. One might make the analogy of a power coupled with an interest — the majority have an agency from each individual, and the stake of the majority in the enterprise gives them an interest which makes the agency irrevocable. From whatever angle we view the situation it is in fact a provision for continuity of group enterprise, to enable the group to keep on functioning in the face of changed conditions which in the opinion of the majority in interest make changes in the corporate structure necessary or desirable.

Various safeguards protect the minority in interest. In the first place, if the matter of necessity or desirability is a matter of opinion, it is not unfair that the minority in interest acquiesce, as they have agreed to do, in the opinion of the majority in interest. In the second place the changes which may be made are only those which the statute authorizes. It must be admitted that this second safeguard is not very valuable. The statutes permit almost any changes, and endeavor to protect the permission by requiring a two-thirds vote for some changes, and in other ways.

If the situation were that existing before the days of general corporation statutes, and each charter were a special grant given in the actual exercise of discretion in the particular instance, and amendable only in a like exercise of discretion, we would have in effect a judge passing on the fairness among stockholders of the proposed amendments. But with the general statutory provisions necessarily broad in the interest of flexibility, and the functions of the State officer acting under them not judicial, but merely administrative, the consent-of-the-State aspect of proposed amendments offers little protection to the minority stockholder. In the third place, if the conduct of the majority amounts to a fraud on the minority, it has the regular remedies in the case of fraud. But fraud, though actual, may be difficult to prove, or the proof may come too late to make the remedy of

value, and many situations short of fraud may nevertheless be oppressive.

If we have classes of stock, the stockholders of each class form a sub-group within the general group, and the interests of the sub-groups may conflict in various matters. In any such matter of conflicting interests, as in the expressed preferences of one stock over another, it ought not to be possible for one sub-group to force a change on another sub-group. But if only one group has the right to vote, even in matters of change in which its interest is adverse to that of another group, we have just the situation in which one group can force a change on another group with an adverse interest.

CHAPTER XV

Bonds

Under our form of economic organization the formula for conducting business provides that wealth used in enterprise may come from owners' contributed capital and from creditors' capital; and the formula classifies creditors' commitment as current or short time, and funded or long time.

Capital used in business — to take a manufacturing or fabrication enterprise as requiring all forms — includes: (1) plant, which comprises land, buildings, and machinery, which are either permanent or of relatively long life; (2) raw materials, entering into the product, and materials used up in the process of manufacture (as lubricating oil and fuel), goods in various stages of fabrication, finished product ready to go into the channels of commerce.

FIXED (OR RELATIVELY PERMANENT) AND CURRENT ASSETS

Land is actually a permanent or fixed asset. In using the word "asset," instead of "capital" or "wealth," we have shifted from economist's to accountant's terminology. Buildings and machinery are "fixed" or permanent in the sense that they are not disposed of out of the business, except as one might consider that as they wear out they have in effect been fabricated into, as an invisible part of, the product of the enterprise. They not only are not, as such, disposed of out of the enterprise, but even in wearing out they are still relatively enduring.

From the viewpoint of financing an enterprise, that is, of providing the capital for it, we are concerned not only with the physical permanence of assets, but, more fundamentally, with permanence of amounts rather than the particular items which go to make up those amounts. If the amounts are continuous through twelve months of the year, and year after year, capital provision must take that fact into account. Capital which is to work, or to

be held ready for working twelve months, expects twelve months' pay. But if capital can be "laid off," perhaps the enterprise will lay it off and save its wages. So there have in fact developed the two distinct types of financing, the financing of those amounts of capital permanently in the enterprise, and the financing of the amounts of capital which are not continuously in the enterprise.

PERMANENT AND TEMPORARY CAPITAL

This division is not exactly between financing the fixed assets of plant and financing the current assets. It would be if there were any part of the twelve-month period in which the current assets entirely disappeared from the enterprise. But there is no time at which it does not have some current assets. And its minimum quantity of current assets is just as permanent in amount as the land, buildings, and machinery. Since this capital is permanently employed those who furnish it will expect payment for its continuous use. Though all of the product of the enterprise is continuously going into the channels of trade and being paid for, carrying into its sales price the cost of such current assets as fuel used in its production, only part of the proceeds can be used to lay off capital. As to some part of it Jones may be paid off $1000; but Smith is called on to furnish $1000 in its place. The capital is not laid off.

Perhaps the thought, which is simple enough in fact, but seems less simple to express, can be made clearer by an example. Assume a corporation which on March 1 has its maximum of assets in the enterprise, and is in this position (not typical of any business that ever was, but simply to present the idea):

Corporate Statement, March 1

Assets	
Cash	$ 100,000
Accounts, etc., receivable	750,000
Inventory (raw materials, goods in process, and finished product)	350,000
Plant	3,000,000
	$4,200,000
Liabilities	
Bank loans	$ 200,000
Accounts payable	400,000
Bonds	1,000,000
Stock	2,000,000
Surplus	600,000
	$4,200,000

We will assume that September 1 is the period of each year in which the corporation has the minimum of current assets, and that on that date the corporate position appears in the following statement:

Corporate Statement, September 1

Assets	
Cash	$ 200,000
Accounts receivable	400,000
Inventory	200,000
Plant	3,000,000
	$3,800,000
Liabilities	
Bank loans	None
Accounts payable	$ 100,000
Bonds	1,000,000
Stock	2,000,000
Surplus	600,000
Profit and loss	100,000
	$3,800,000

It will be noted that the variation in total assets between the maximum and minimum periods of the year is $400,000. At the minimum asset period only $100,000 of current liabilities appear. The picture would be clearer if this item, like bank loans, were reduced to zero; but experience will not permit even imagination to go so far. So we have $400,000 of capital required in March which will not be required in September. If the decline from March to September, and the rise from September to March, were exactly even, $66,666.66 of capital goes out of use in the business each month for six months, and comes into the business each month of the succeeding six months. This capital, which is not continuously used, need not be continuously paid for. It is financed by accounts payable, and by bank loans, and these can be diminished as the inventory and accounts receivable diminish.

Assuming that the business would not require bank balances of cash of more than $100,000, we have a residuum of $3,700,000 of capital permanently employed in the business. Of this the $400,000 of accounts receivable are essentially goods. Though legal title and possession of the goods passed, payment has not yet been made in this amount of $400,000. This September 1 minimum amount of goods on hand (inventory) and goods sold but not paid for is not in fixed assets in the sense of assets continuously

in the business. These assets are part of the flow of goods in consumption. But, to repeat, though the things change, the amount is permanent, and represents capital continuously in use. Though the items liquidate, the amount does not. Since the amount does not liquidate, it must be as permanently financed as the physically permanent items of plant.

In our example we see the non-permanent capital amount of capital financed by bank loans and accounts receivable. As the non-permanent capital went out of the business, bank loans and accounts payable were reduced until the business was "out of the bank," as the phrase is, and the accounts payable reached their minimum amount. On September 1 payment is not being made for the use of $400,000 of capital which was being paid for on March 1.

PERMANENT CAPITAL FINANCED BY STOCK AND FUNDED DEBT

On the other hand the business requires $3,700,000 of capital continuously. (The assumption that only $100,000 of the $200,000 cash of September 1 was really needed should be remembered. This may be deemed to constitute a margin of safety in the financing.) Of this $3,700,000, the amount of $1,000,000 is financed by the funded debt of $1,000,000 in bonds, and $2,700,000 is being financed by the stockholders. For, assuming that the stockholders paid $2,000,000 for the aggregate of the stock, they now have further in the business their accumulated profits, represented by the $600,000 of surplus and $100,000 of profit and loss.

Nothing in the financing of the non-permanent capital is peculiar to the corporate form of enterprise. It is all part of the formula of business as it is conducted under whatever type of organization. Even owners' capital in the corporate form is not essentially different from owners' capital in any other form. To be sure, in individual and partnership enterprise the law does not prohibit the withdrawal of owners' capital to any amount, and in corporate enterprise does limit payments to owners to those which may be made and leave the corporate capital stock unimpaired. But, practically, individual and partnership owners cannot continue an enterprise on an existing scale and withdraw any of the permanent capital. Its permanence is a necessity arising out of the nature of business.

LIMITATION ON FUNDED DEBT FINANCING IN INDIVIDUAL AND PARTNERSHIP ENTERPRISE

Capital financed with long term debt is, however, almost, if not quite, peculiar to the corporate form (and the trust form, which in so many respects is analogous to the corporate). Individuals and partnerships meet very practical difficulties in considering the possibility of financing with long term debt. Duration of individual life is uncertain. A long term debt created to finance a business may hamper the settlement of a decedent's estate. Even though the death of the decedent make the claim payable, the debt may nevertheless have been impracticable.

Long term indebtedness for business is created with an anticipation of amortizing the debt out of earnings, and of having the term of the debt sufficiently long to permit such amortization; or it is created with an anticipation of refunding at maturity. Neither course is practicable for an individual enterprise. Only payment will free the legal representative of the decedent from liability for payment out of the decedent's estate. Assets of the estate other than those of the business may not be sufficient to meet the liability. A purchaser of the business assets must be found who will pay cash. A thirty-year debt has too many hazards both for the borrower and for the lender in the case of the individual enterprise.

The ordinary mortgage on dwelling house or commercial premises creates quite sufficient embarrassments in the settlement of the decedent's estate, and such property is generally much more vendible than that of a going business. The same difficulties arise in the case of partnership enterprise. Death of a partner dissolves the partnership and requires liquidation sufficient at least to settle the deceased partner's interest. Though long term debt, to be sure, would only accentuate the difficulties of liquidation of a decedent's individual or partnership enterprise, this accentuation is the bit too much to hazard.

FUNDED DEBT FINANCING OUTSIDE THE REAL ESTATE FIELD PECULIAR TO CORPORATE ENTERPRISE

Anticipated continuity of the corporate group, however, permits the hazard of long term debt. A chance may be taken that the group will exist for the term of years; so the debt is incurred, with the anticipation of amortizing it out of earnings, or of refunding it. Insolvency is not so much of a difficulty in the case either of

individual or of corporate enterprise. On insolvency all the assets must be applied towards the satisfaction of creditors. On the death of a solvent decedent, however, his legal representatives may not safely pay anything to beneficiaries of his estate until creditors are satisfied. A corresponding situation arises in corporate enterprise only on the dissolution of the corporate group while the enterprise is solvent, and it is not generally anticipated that this event will take place. If it does, the difficulties will arise. But, as we shall see, in the corporate enterprise they can be anticipated and contractually provided for, as they cannot be in the case of individual enterprise, because the kind of contract is not customary, and is not acceptable to the parties concerned.

Long term corporate debt can be contracted with a provision that, on the sale of the corporate assets and business to another corporation, which assumes the debt, the original corporation obligor will be discharged from liability. A transaction under this provision leaves the creditor in substantially the position he was in. It is susceptible of manipulation to his detriment, however. But, broadly, the only security the creditor has at any time is the assets of the business.

He cannot make the members of the corporate group personally responsive out of their non-corporate assets. As for the value to him of the control of the enterprise by the particular group, he cannot prevent a complete change in the personnel of the group. The fact that a new corporate group has acquired the business is no injury to the creditor. So he is willing to make the contract for the substitution of corporate liabilities. But he would not ordinarily be willing to make a contract for the substitution in case of an individual liability.

Thus we find that frequently, one might say customarily, a substantial part of the permanent capital amount of corporate enterprise is financed by debt which is not current, or liquidating as the product of the enterprise flows into consumption. Through such financing the owners of the enterprise, by accepting the greater risk, have the chance of the greater profit involved in trading on the equity, which we will discuss later. And the more types of investors who can be appealed to, the more readily the capital sums involved in an enterprise can be procured. These two things are the basis of variations in the terms of capital commitment contracts, whether creditor or stockholder, and of classes of creditor and stockholder contracts.

AUTHORITY TO CREATE DEBT

Corporation statutes regularly authorize corporations established under them to create debt. The draftsman of a corporate charter repeats this authority by the express terms of the certificate. Since the incurring of debt is one of the ordinary means by which business is carried on, the authority of a corporation might be implied. If the corporation statute authorized the creation of indebtedness, presumably it is not necessary, however good form, to repeat the authority in the certificate of incorporation. Those who manage corporate affairs rest easier, however, if they have a clear line of authority in both the statute and the charter.

Ordinary interrelations of directors and officers take care of current indebtedness. Directors may place on officers any limitations they see fit. We will not delay to discuss doctrines of scope of authority in this connection, and the effect on a creditor if an officer exceeds some directors' limitation on his authority. That is a long story, and we are assuming that lines of authority are followed.

Speaking broadly, the only limitation generally placed by States on the authority of directors to create debt is not on the creation of debt as such, but on securing it by mortgage of the corporate assets. Some jurisdictions have other restrictions — as that the total indebtedness shall not exceed a statutory ratio to the capital stock. But we will not enter on a consideration of such limitations. However, a cautious board of directors will not undertake to finance any large fraction of the corporate capital by a funded debt, even though unsecured by mortgage, without referring the matter to stockholders for authority. The transaction is out of the ordinary course of the corporate business. It affects fundamentally the risk of the stockholders. Directors ought to have stockholders' approval in undertaking it.

AUTHORIZED MORTGAGED DEBT

If the debt is to be secured by mortgage the directors must get stockholders' authority to create the mortgage, and this involves authority for the amount of debt to be so secured. So we find an authorized mortgage debt as well as an authorized capital stock of a corporation. We will defer consideration of the mortgage security to later chapters, and at this point discuss only the corporate debt.

EVIDENCE OF THE DEBT

A corporation may have only a book account (accounts payable) evidencing ordinary current indebtedness, or it may give its promissory notes, or accept bills drawn on it (trade acceptances). These, as indeed is the case of evidences of longer term or funded debt, differ from the corresponding instruments of individuals only in the corporate form of execution, and in the derivative authority. A resolution of the board of directors states what officers have authority to execute such instruments, and, if their authority is limited in any way, the extent of the limitation. The corporate name is signed in the following manner:

Universal Milling Corporation
by John Jones
President
Henry Smith
Treasurer

If the instrument is a note the fact states that "Universal Milling Corporation promises," etc., and correspondingly for an acceptance. These instruments do not ordinarily carry the corporate seal, which in their case would be only a part of the corporate signature. If the debt is other than the ordinary current indebtedness of the business, which is evidenced as just indicated, it will usually take the form of a bond, though, as we shall from time to time see in the consideration of types of securities, other forms are used.

BONDS

Bonds as distinguished from notes and bills are instruments under seal — "specialties" the lawyer calls them, and calls their promises "covenants." This is not a law book, however often it must refer to the legal foundation of its subject, and is no place to enter on the long history of the development of various forms of promise, or, more than necessary, of current distinctions. Perhaps so much of the contractual doctrine of consideration has attached itself to instruments under seal, that a seal is of little value to the creditor from the viewpoint of overcoming a defense of no consideration. The statutes of limitation of the various jurisdictions, however, make a distinction of requiring a longer term be-

fore the statute can be pleaded as a bar to a sealed instrument than for an instrument not under seal — common periods are six years for the instruments not under seal and twenty years for instruments under seal.

The Uniform Negotiable Instruments Law states that the negotiable character of an instrument is not affected by the fact that it bears a seal. But in any particular case question may arise as to whether provisions of the corporation bond, and especially of the mortgage securing it, the terms of which are incorporated in the bond by reference to the mortgage, contain matters which do not satisfy the requirements of negotiability. However that may be, corporate bonds in coupon form, payable to bearer, are generally dealt in on the layman's assumption that they are negotiable.

A corporation seal has two functions: it serves as part of the formal corporate signature, and, when so indicated, it serves to create an instrument under seal, a specialty. The corporate seal affixed to the ordinary form of corporate promissory note would not, presumably, be taken to create a "sealed" instrument, but the corporate seal attached to a form of bond which states that the instrument is signed and sealed, especially as taken with other language of the bond, would be taken to indicate an instrument under seal. The word "bond" itself indicates a sealed instrument.

CORPORATE "NOTES"

Corporate promises to pay, with a maturity of from one to five years from their issuance, are generally called "notes" in the language of the Street. And they may indeed be notes, that is, promises to pay not under seal; but in more instances they are bonds, instruments formally under seal, differing from any other bonds only in running for the relatively short time. All of this matter about the distinction between sealed instruments and instruments not under seal is not very important for the business man, except that it needs to be understood in order to understand financial terminology.

COUPON BONDS

Coupon bonds are payable to "bearer," and have coupons attached to represent the instalments of interest. Each coupon is in effect a separate promissory note, promising to pay the amount of the interest instalment on its due date. The bond itself is es-

sentially the promise to pay the principal. If the bond runs for twenty-five years, that is, promises to pay the holder $1000 at a date twenty-five years from the date of the bond, with interest at the rate of six per cent per annum, in semi-annual instalments, on the first day of each February and August, on the presentation and surrender of the respective coupons therefor attached, the bond will carry fifty coupons, one falling due on each of the stated interest dates. The whole paper amounts to fifty-one separate instruments, the bond itself promising to pay the principal, and containing the supplemental promise to pay the interest, but only on the surrender of the coupon for it. Nothing in the nature of the document prevents the fifty-one instruments from being severed from each other, and dealt in separately for what each is worth. But in practice, anyone offering to buy the bond means that he offers to buy it with all the unmatured coupons attached, and can, and will, refuse to accept delivery of the bond and pay for it unless he receives with it all the coupons not yet due. Interest is collected by clipping the coupons and presenting them for payment, just as any promissory note is presented. In ordinary practice the owner simply deposits them in a bank where he has an account, like any check, and the bank credits them to the account subject to collection, and makes the presentation and collection through the regular banking channels.

REGISTERED BONDS

A registered bond is not payable to bearer, nor to the order of a named payee, but only to the person whose name is inscribed on the books of the corporation as the person entitled to receive payment. Therefore, it is not a negotiable instrument. Since the corporation has the name and address of the owner, it pays the interest instalments by check mailed to the order of the owner, just as in the case of dividend payments. It is protected in doing so until the bond with an assignment to another person is presented to the corporation for a transfer of the corporate record ownership. Since possession of the bond indicates ownership, and the consequent right to transfer it, the corporation will not make the transfer without the surrender of the bond, whereupon it issues a new bond registered in the name of the new owner, or simply endorses the name of the new owner on the back of the bond transferred and delivers it back to the person who presented it for transfer.

INTERCHANGEABLE

Sometimes, and especially with large loans, bonds are not only issued in both coupon and registered forms, but the forms are made interchangeable. The man who owns a registered bond can exchange it for a coupon bond, and vice versa. This entails a good deal of labor and involves the necessity of having blank forms of both classes — or forms executed by the corporation and ready for certification by the trustee; or by the transfer agent, if the issue does not involve any indenture of any kind of trust making a trustee necessary. Generally only the largest issues provide for this interchangeability.

Only a small percentage of any issue is, in practice, in registered form. The custom of the bond market makes the usual dealings in the coupon form. Indeed the labor and delay of transfer, though not great, usually cause registered bonds to sell at fractionally lower prices. Habit, the customary thing, plays a large part in financial dealings. As a matter of fact, it is no more difficult to transfer registered bonds than it is to transfer stock. And stock transfers are so familiar that no one thinks of them as being especially a hindrance to dealings. The receipt of interest by check is much more convenient than the process of clipping coupons. To speak of the work involved in clipping coupons may sound humorous; but it is not inconsiderable, involving as it does a visit to the safe deposit box by the owner, preparation of a certificate for the Federal income tax authorities, and the entry of information on the deposit envelope required by the bank. Yet the customary usage of coupon bonds probably will not soon change.

REGISTERABLE AS TO PRINCIPAL ONLY

A device intermediate between issuing both coupon and registered bonds, and making them interchangeable, is to issue bonds with coupons attached, but registerable as to principal. Under this plan the coupons remain completely negotiable; only the principal is protected by registration. The registration is noted on the back of the bond and entered in the books of the corporation. At any time the bond can be discharged from the registration and reconverted into the bearer form. In this way the corporation needs to provide only the original instrument. If a thief should steal the bond, detach the coupons, and attempt to

sell them separately, the transaction would be so unusual that it seems likely that the buyer would be "put on inquiry" and unable to maintain that he was a purchaser for value without notice.

However this may be, the "registerable as to principal only" device is convenient in situations which do not justify complete provision for interchangeable coupon and registered bonds. In spite of the general custom of coupon bonds, some people want the protection of registration. A man who is a fiduciary investing trust funds, for example, conceivably might be held negligent and personally liable if, in spite of care in other respects, coupon bonds representing trust funds were lost or stolen, with the possibility of a purchaser for value without notice acquiring good title.

CONVERTIBLE BONDS

Since the subject of convertible securities has already been considered in connection with convertible stocks, it requires little or no further discussion here. Options may be given in creditor securities, making them convertible into other creditor securities, or into stock. But stock may not be made convertible into creditor securities, except that presumably it might be made so convertible under conditions that would protect any impairment of the corporate capital stock.

REDEEMABLE BONDS

Bonds may be, and frequently are, issued subject to redemption prior to maturity, for the same reasons that preferred stock is made redeemable, reasons which are even more cogent in the case of bonds. We will defer consideration of the redemption of bonds to a later general discussion of the amortization of corporate debt. At this point we will remark only that in the case of the redemption of bonds the problem of taking care that the capital stock shall not be impaired does not arise, except as to discounts and any premium that may be involved in the redemption. For illustration of the premium situation assume a corporation in this position:

Assets	
Total assets	\$2,000,000
Liabilities	
Bonds	\$1,000,000
Capital stock	1,000,000
	\$2,000,000

Assume further that the bonds are redeemable at 110, and that the directors do in fact redeem the entire issue at that price. The results would be:

Assets

Total assets	$ 900,000
Deficit	100,000
	$1,000,000

Liabilities

Capital stock	$1,000,000

The directors have voluntarily disposed of assets in such a way as to impair the capital stock. They have not, to be sure, made any distribution to stockholders, but query: whether they have a right to make any payment, which they are not obliged to make, that results in an impairment of the stock values to protect creditors. One assumes that the directors should not so act. If the corporation has a surplus against which the. premium can be charged, the situation is entirely different.

FORMAL TERMS OF BONDS

A bond as evidence of a creditor contract has certain formal terms. These are: (1) date of the bond; (2) maturity of the bond; (3) denomination; (4) interest rate; (5) interest dates. We will consider them in the order stated.

DATE OF THE BOND

The date of the bond establishes the point of time from which interest begins to run. This formal date may not be, and indeed seldom is, the date either of actual execution or of delivery. It is executed and delivered "as of" that date. But the first coupon matures six months from that date. Since the issuing corporation becomes bound to pay the full six months interest at its stated due date, it receives from the purchaser the stipulated price plus the accrual of interest to the date of delivery. As the bonds are sold by the purchasing bankers, they in their turn collect the accrual of interest to their date of delivery, and so are reimbursed for the accrued interest they paid the corporation, plus the coupon rate of interest for the period they have carried the bonds.

MATURITY

Each bond gives the date at which the principal sum becomes due. (Except sometimes creditor securities are issued which carry no obligation to repay principal at a stated time. These will be discussed later.) The due date is the "time certain" for payment, on which failure to pay is a default giving rise to a right of action. Each interest instalment has its own due date, on which failure to pay is a default in payment of interest. Regularly bonds contain a covenant that default in payment of interest will cause the principal to fall due (called an acceleration of maturity clause). With such a provision a right of action arises for the whole sum, principal and all interest due; without it only the interest due can be sued for. Judicial proceedings for liquidation on insolvency cause a like acceleration of maturity by operation of the law. As already seen, the bond may carry an option giving the corporation a right to make payment before the maturity date, either at the face amount of the bond or at a premium, and at such times or within such times as the option provides.

DENOMINATION

The standard denomination or face amount of a bond is $1000. It is the sum promised to be paid at the due date. It is common, however, to include some $500 coupon bonds in an issue. Registered bonds are usually in denominations of $1000 and $5000. Sometimes part of the bonds of an issue are put in the denomination of $100; they are popularly called baby bonds. During the war, the Federal Government issued many bonds of this denomination, and even of smaller face amounts. Such bonds are not usual in large corporate issues. The cost of marketing is too great for the bankers, and the cost of providing them, and taking care of the small interest payments, too great for the corporation. Each denomination requires separate printing for both the face of the bond and the coupons. There is no real social need for them. Until a man can invest in amounts of $1000 he had better keep his funds in a savings bank or in some other form.

INTEREST RATES

Certain nominal or coupon interest rates are customary, as four, four and one-half, five, five and one-half, and six per cent.

During the past quarter century nominal rates have come into use in the quarter per cent fraction; and during periods of high interest rates, nominal rates in excess of six per cent have appeared. Since bonds are mostly in coupon form, the Street uses the term "coupon rate" rather than "nominal rate," which is a term used in the mathematics of investment. The rate is called nominal because, in the primary sense of the word, it is the rate named; and because, in the secondary sense of the word, if the bonds are issued or sold for a sum different from the exact amount promised to be paid at maturity, the rate does not represent the actual cost to the debtor of the money loaned.

BASIS RATE — DISCOUNT BONDS

If the debtor corporation issues the bonds at a discount, at the maturity date it pays the amount of discount in addition to the nominal or coupon rate for the use of the money. Let us make the matter specific. The corporation issues twenty-year five per cent bonds at 80. For each bond promising to pay $1000 on the due date twenty years from the date of the bond, it receives only $800. On this it pays in current interest $25 each half year, which amounts to semi-annual interest at the rate of 6.25 per cent per annum. But this is not the end of the matter. At the end of the twenty-year period it will have to pay $1000, which is $200 more than it received. Investment recognizes only two elements of accounting — principal and interest. From this viewpoint, since the principal sum actually paid by the purchaser and received by the corporation was $800, the $200 is interest, which was not actually paid out currently; but the obligation to pay accumulated and was met by actual payment at the end of the twenty years.

Payment of $200 at the end of twenty years is not the same thing as the payment of $5.00 every half year for the forty semiannual periods of twenty years. The element of compounding enters. We have a problem of compound discount. Expressed in mathematical terms, the interest equivalence of this $200 of discount is the instalment of an annuity which, compounded at x rate of interest, would amount to $200 at the end of the period. But the fact that the interest rate to be used in the computation is 6.25 per cent plus the very amount we are seeking to find creates a mathematical difficulty. Though it is solvable, we will not consider it any part of the purpose of this work to present the so-

lution. We should be clear, however, that the true or effective rate of interest is different from the nominal or coupon rate, and understand the essential reasons back of the difference. The true rate is commonly called the basis rate of the bond.

BASIS RATE — PREMIUM BONDS

If the bond is issued at a premium, we have the reverse of the problem just presented. Assume a twenty-year five per cent bond issued at 110. The purchaser pays and the corporation receives the principal sum of $1100, on which it pays currently semi-annual instalments of interest of $25. This amounts to semi-annual interest at the rate of 4.54+ per cent. But at the end of the twenty-year period the corporation will pay and the bondholder receive only $1000. The face amount of the bond and the principal sum are not the same thing. It should be remarked that the face amount is sometimes called the principal sum. When so called the situation is not looked at in a strictly accurate way, but arises from considering the discount as representing interest collected in advance. In the case of the premium bond the principal is $1100. But the sum repaid on the due date is only $1000. Some of the principal has disappeared by that time.

If the principal is to be kept intact part of each semi-annual payment of $25 must be regarded as a repayment of principal, namely, so much as, compounded at x rate of interest, would amount to $200 at the end of the twenty-year term. Fifty dollars a year, in the two semi-annual instalments, less the amount to be compounded, would be the true interest amount received on the $1100 of principal. We have the same difficulty, however, as with the discount bond. The rate at which the compounding is to be computed is the very rate we are seeking. The situation has been explained in this way, not as a clue to the mathematical solution, which this approach does not give, but merely as an endeavor to make clear that the coupon interest rate is simply a part of the investment contract, and does not indicate the actual rate of interest on the investment.

DETERMINATION OF COUPON RATE

What determines the selection of a coupon rate for an issue? From the viewpoint of the corporation, bonds tend to sell most

advantageously, or at a lower true interest cost for the money borrowed, if sold at a discount. It is seldom that the credit of a given corporate borrower in the money market is exactly four and one-half, or five, or five and one-half, or six per cent, the customary coupon rates.

For illustration, let us assume that the credit of the borrower on the terms of the security offered, as mortgage bond or debenture, with its special provisions, is approximately 5.70 per cent. The borrower has the choice of issuing five and one-half per cent bonds at a discount or six per cent bonds at a premium. It will make a better bargain by offering five and one-half per cent bonds at a discount; it might be able to sell five and one-half per cent bonds at a 5.68 basis, when it would have to sell six per cent bonds on a 5.72 basis (the figures showing this difference are only illustrative of the principle). So the five and one-half per cent coupon rate is selected.

Investors prefer discount to premium bonds. If they hold to maturity a discount bond, on which the coupon interest is regularly paid, and on the due date receive the face amount, they actually realize the computed true rate of interest. That part of the computed true interest which they do not receive currently is, so to speak, being compounded in the bond itself; for the discount amount received at the maturity of the bond is that part of the interest not paid currently compounded at the true interest rate.

When, however, an investor purchases a premium bond, he has no such automatic and mathematically accurate compounding of an amount to amortize the premium. If he buys a six per cent twenty-year bond at a price computed to yield 5.70 per cent, he will not in practice be able to invest and compound the small amounts of semi-annual amortization instalments at exactly 5.70 per cent. He will not actually gain the 5.70 per cent on his investment. This fact is also part of the reason why a bond price in the market moves towards par more easily than it moves above par. So a discount bond is more favorable to a possible profit through an enhancement in price than a premium bond.

Besides this marketing advantage of the discount bond the borrower may prefer the temporarily easier terms of a five and one-half per cent current payment, deferring for twenty years the payment of the additional one-fifth per cent. Setting aside a reserve to amortize discount affects the accounts, but does not require the payment out of cash, and the bookkeeping transaction is often

much easier than the provision of actual cash for payment. Conversely, if the corporation sells a premium bond, it must in six months begin the repayment of part of the principal; that is, it is actually paying out the coupon six per cent instead of the true interest of 5.70 per cent. So if the managers of the enterprise are at all inclined to live on hopes, and see twenty years as an evil day long deferred, the pressure for the discount as opposed to the premium bond is strong. But the fact that a better actual bargain can be made with a discount bond is a sound business reason for issuing it.

Custom is a strong element in the securities business. It is adjusted to the customary coupon rates. The computations for them have all been worked out and the results printed in the "basis books," which are in constant use in bond transactions. If a corporation should attempt to issue bonds carrying a coupon rate of 5.70 per cent, it would be offering something not only unfamiliar but inconvenient. The corporation would not be able to make as good a bargain for an unusual coupon rate as for a usual rate for sale at a premium. And even if a coupon rate just equal to the true rate were adopted, and the bonds issued at par, the course of the market would soon make them sell at a premium or a discount with all the problems involved.

INTEREST DATES

Standard terms of interest payments call for semi-annual instalments, and the months fall into their familiar pairs of this purpose: January and July; February and August; March and September; April and October; May and November; June and December. Though sometimes coupons are made to fall due on the fifteenth of the month, the usual interest date is the first.

GOLD BONDS

The words "Gold Bond" frequently form a part of a bond title, as "The six per cent twenty-year First Mortgage Gold Bonds of the National Milling Company." They refer to the covenants contained in the bond promising to pay the stated face amount "in gold coin of the United States of or equal to the present standard of weight and fineness." The stock of paper money of a country can be increased indefinitely at a negligible

cost of production, but unless some discovery of new sources of gold supply, or some invention for the production of gold, such as has not hitherto been made, should take place, the stock of gold can be increased with relative slowness and only at substantial cost. No discovery or invention is needed for the increase of paper money. So, in making a long term loan the lender prefers the hazard of the value of gold, that is, its relation to other commodities, to the hazard of the value of other currency.

In the course of discussion in 1931–32 of the possibility of the United States going off the gold standard, question arose as to the probable effect of the gold covenant, inserted primarily as a precaution against that very situation. The general authority of the Federal Government to make its currency legal tender was settled in a series of decisions after the Civil War.[1]

The case of *Bronson v. Rodes* (1868) decided that greenbacks (notes not redeemable in gold on demand) "were not legal tender in the settlement of contracts specifically calling for the payment of a specie." [2] Our Constitution (Art. 1, Sec. 10) provides that "No state shall *** coin money *** make anything but gold and silver coin a tender in payment of debts; pass any *** law impairing the obligation of contract." The Constitution, however, contains no correlative prohibition to the Federal Government. It gives Congress the power "To coin money, regulate the value thereof, and of foreign coin." (Art. I, Sec. 8, Par. 5.)

Joint resolution of Congress, June 5, 1933, declared against public policy "every provision contained in or made with respect of any obligation which purports to give the obligee a right to require payment in gold or a particular kind of coin or currency, or in an amount of money of the United States measured thereby."

The resolution provided that "Every obligation heretofore or hereafter incurred, whether or not any such provision is contained therein or made with respect thereto, shall be discharged upon payment, dollar for dollar, in any coin or currency which at the time of payment is legal tender for public and private debts."

A series of Congressional enactments and executive orders thereafter changed the gold content of the dollar from 28.5 grains

[1] For a succinct summary the reader is referred to Arthur S. Dewey, *Financial History of the United States*, Ninth Edition, pp. 362–367.

[2] *Bronson v. Rodes*, 7 Wall. 299.

to $15\frac{5}{21}$ grains, and impounded all gold coin, gold bullion, and gold certificates.

In the case of *Norman v. Baltimore and Ohio Railroad Company* (294 U. S. 240), the Supreme Court of the United States, on February 18, 1935, by a five to four decision, declared these measures constitutional, as far as they affected the usual gold clause in private corporation bonds, which the Court found a void part of the agreement under circumstances before it.

The promise in the bond before the Court was in the customary form, to pay principal and interest "in gold coin of the United States of America of or equal to the standard of weight and fineness existing February 1, 1930." The Court found this a promise to pay "money," as, indeed, the words "gold coin" imply. Seeing also an intent to create a negotiable instrument, which must be payable in money, added strength to the idea of a money promise, and subtracted strength from the idea of an intent to deliver a commodity, gold bullion, or a value equivalent. The Court was able to distinguish *Bronson v. Rodes,* because at the time of that case, 1868, gold specie still circulated, so that there were two kinds of money, greenbacks and gold, and a promise to pay in one kind could be enforced. This outline very slenderly presents the reasoning of the majority of the Court, but perhaps sufficiently for our purpose.[1]

[1] The Supreme Court, at the same time that it gave the decision in *Norman v. Baltimore and Ohio Railroad Company,* also decided the case of *Perry v. U. S.,* 294 U. S. 330, relating to the rights of an owner of a bond of the United States containing a clause that the principal and interest were payable in gold coin of the standard at the time of the issuance of the bond. In effect the Court said that though Congress has no power to repudiate obligations into which it had entered, the United States, as a sovereignty, could not be sued without its consent. Further, it did not appear that the bondholder had sustained any loss in buying power, and on the devaluation of the dollar in terms of gold and the restriction of gold payment, he was not entitled to payment in currency of more than the amount of the face of the bond. One may remark that though the domestic price level had not changed substantially at the time of bringing the action, and the bondholder may not have proved that he suffered loss, nevertheless he had suffered a loss in the power to buy foreign goods proportional to the amount of debasement of the currency.

Nortz v. U. S., 294 U. S. 317, also decided at the same time, dealt with the gold certificates. As stated in the head note: "An owner of gold certificates of the United States *** does not sustain a loss for which he is entitled to be compensated in being compelled to surrender such certificates in exchange for legal tender currency of an equivalent face amount, then on a parity with the gold dollars represented by the certificates, although at the time of being required to surrender the certificates the market price of the gold represented by the certificates was in excess of the currency received."

One might wonder why an intent to create a negotiable instrument (perhaps of doubtful negotiability in spite of money payment) should outweigh an intent to obtain protection against depreciation in the currency. Still the lawyers drafting this clause, and repeating it, overreached themselves in trying to accomplish too much. They did want to create a negotiable instrument, if they could in the face of possible various contradictory matters in the bond and indenture. Hence the language indicating terms of money payment. Doubtless they could not imagine such a thing as the stoppage of gold payment and the impounding of gold.

These events shake the foundation of all long term money contracts, and the endeavors of the investor for economic security through them. They may well not be altogether unproductive of good, however much of immediate injustice they work. One may believe that we have too greatly elaborated the function of credit in business and that both investor and enterpriser would be far better off with an increase in the equities of ownership.

TAX COVENANT BONDS

Bonds often contain a covenant to pay interest without deduction for any tax, assessment, or governmental charge which the issuing corporation or the trustee for the same may be required to pay or retain or deduct under any present or future law of the United States, or of any State, county, municipality, or other taxing authority therein. The writer surmises that this clause had its origin in the Federal income tax law of the Civil War period which contained a collection at the source provision.

The Federal income tax adopted on the passage of the Sixteenth Amendment to the Constitution in 1913 likewise contained a provision for collection at the source, which required corporations issuing bonds to retain and pay to the Federal Government the amount of the "normal tax" on the sum of interest paid. By this time purchasers of bonds would not have thought of inquiring about the tax covenant clause, and would have paid as much for bonds without it as for bonds with it. The clause was repeated in new issues as a matter of routine.

Since the normal tax rate under the revenue act of 1913 was only one per cent, the matter was not even then highly important. When the act of 1916 increased the rate to two per cent the sig-

nificance of the clause became more impressive. It was seen that the rate might be further increased. Lists of bonds containing the tax covenant were made up, and the clause, which the corporation honored without question, came to have an element of value entering into the market price.

When the United States entered the World War, and greatly increased taxation became imminent, the tax covenant threatened the corporations with substantially increased charges. They had agreed to pay any tax which they might be required to pay, retain, or deduct. If the government should abandon collection at the source the clause would not be operative. In the meantime bond buyers had been paying prices which included the value they expected to receive from the clause. The government in its revenue law of 1918 increased the normal tax for that year to six per cent on taxed income up to $4000, and to twelve per cent on taxed income above that. As a compromise of the conflicting interests of the bondholders and the corporations in the matter of collection at the source, the act required the corporations to withhold only two per cent. That provision was continued in subsequent acts, and is the situation at the time of writing. In the meantime the drafting of the tax covenant has been modified, so that when it is used, and it is still common, its promise is to pay without deduction of any tax, assessment, or governmental charge, *other than Federal income taxes in excess of two per cent per annum.*

PLACE OF PAYMENT

As a general principle the debtor must seek his creditor to make payment, in the absence of stipulation to the contrary. There may be exceptions, as that if the creditor were in the same jurisdiction as the debtor at the time of making the loan, and afterwards removed from the State, the debtor may not be obliged to follow him. But, of course, in large corporate loans the contract specifically states the place or places of payment, as a bank or trust company in one or more cities.

If the bonds are to be sold in more than one country, a place of payment in each country may be named, and payment provided in the currency of that country at a fixed rate of exchange, which is regularly made the gold parity of the coinage of the country of the place of payment with that of the country of the

issuer. The undertaking is to pay the stated amount at any one of the places named where presentment for payment may be made. If exchange runs against the country of the issuer this undertaking may cost it substantial amounts. Wherever a holder of the bonds resides he is likely, if the covenant permits, to take his payment at the point where the exchange is most advantageous to him, and most disadvantageous to the corporation.

Yet on an international sale the issuer practically must covenant to pay in each country at a fixed rate of exchange or in gold. But the covenant may restrict such payment to that part of the loan sold in such country. The investor is generally unwilling to accept hazards of foreign exchange that may result in his receiving less than the anticipated amount. If bonds are distributed widely in the United States an agreement to pay in New York and Chicago, and possibly at other points, aids in their sale.

MORTGAGE BONDS

Bonds may be secured or unsecured. If secured, the security may be by pledge of other securities, by a chattel mortgage (or an equivalent security of conditional sale), by mortgage on real property, or by a combination of any two or more of these types of security. Strictly the word "mortgage," used without any qualifying adjective, implies the security of real property. But a corporate mortgage generally carries at least some tangible personal property also, and to that extent is a chattel mortgage as well as a real property mortgage.

A mortgage on a manufacturing plant would include not only the land and buildings, but also the machinery. Some of the machinery might be regarded as so attached to the realty — the building — as to be a part of it, and therefore real property, but probably much of it could not be so regarded. Security for the loan is not just land and buildings, but a plant capable of turning out goods and earning money. Equipment used in the operation of the plant would be included in the mortgage.

A variety of terms intended in some degree to indicate the nature of the security are used in connection with mortgage bonds. "First Mortgage" explains itself. A mortgage, however, may be "first" on some of the assets, but "junior" (i.e., having a mortgage ahead of it) on other assets. In that case the mortgage may be described as "First and General." If the mortgage is

described as "First and Refunding" it means that at least part of the authorized amount of bonds is reserved for issuance to pay off bonds secured by a superior or "senior" lien, and (generally) maturing substantially earlier than the maturity date of the refunding issue.

If a mortgage is not "first" on any part of the assets, the bonds it secures would be described simply as "general" or "refunding" bonds, or in some corresponding manner. No one should assume much about the actual security from the bond name alone, but should ascertain by investigation just what the security is. Since we will consider later the whole topic of mortgage security, and in various places discuss situations which give rise to certain types of security, we will not go into the matter further at this point.

COLLATERAL BONDS

If other securities — stocks or bonds — are pledged (by transfer to the trustee under the indenture in accordance with the terms of which a corporate funded debt is created) the securities issued are called "collateral bonds." Since situations giving rise to such bonds will be presented later at various points, we will not discuss them further now.

DEBENTURES

Financial nomenclature in the United States calls bonds which have no specific security "debentures." The word (from the Latin *debere*) indicates merely a debt, and derivatively has nothing to do with security or lack of it. British terminology uses it as the generic word, and in this usage the debenture may be secured or unsecured. In the United States the generic word is "bond." With us a bond is secured or unsecured, and a debenture is an unsecured bond or one secured only by odds and ends of personal or real property. They usually, however, contain restrictive covenants limiting the future borrowing or dividend payments of the debtor.

DEBENTURE STOCK

British practice has developed a type of security, a characteristic of which is the transferability of a share in the debt, evidenced by a certificate and transferred like shares of stock; hence,

"debenture stock." The debt may or may not be secured by a mortgage, but is likely to be secured by a "floating charge," so that as long as the corporation is not in default, it may deal with its assets free from mortgage or lien; but on default a lien attaches to the assets in favor of the debenture stockholders.

For the creation of creditor securities, as for stock, there is a wide latitude of contract concerning the elements of risk, income, and control. Stock represents the residuary rights after those which have been disposed of to creditors. With respect to the residual the shareholders may contract among themselves by a classification of shares. Although classes of creditors arise, they do not originate in contracts between groups of creditors, but because the stockholders have granted rights to one group of creditors, and out of the rights remaining have granted other rights to another creditor group.

Creditors fall into groups of those who have exactly the same rights. These groups need not be organized on their formation. And they need not function as groups unless liquidation or reorganization proceedings, seeking to maintain equality among creditors of the same class, sort them out for the purpose of equal treatment of members. If a single security is given to the makers of a group loan, however, we have a formal organization of the lending group from the beginning, through the functioning of the trustee holding the security. It is necessary to provide a process for making the single property, given as security for the group loan, available pro rata to the members of the lending group.

CHAPTER XVI

Mortgages

A student of corporate financing cannot comprehend the subject unless he understands corporation mortgage bonds. He cannot understand these instruments unless he knows something about corporation mortgages. And he cannot know anything of real value about corporation mortgages unless he has some knowledge of the rights and liabilities of the parties to an ordinary individual mortgage. For the corporation mortgage simply utilizes certain devices, or concepts of the law, which enable a group of creditors to supply funds for the corporate enterprise as if they were one creditor; and each to have the benefit of the same mortgage security without preference or priority one over another. We have another illustration of mechanisms for group action developed for the massing of the amounts of capital necessary for large scale enterprise.

MORTGAGE ONE OF THE DEVICES FOR THE FUNCTIONING OF SOCIETY BASED ON PRIVATE PROPERTY

Since the mortgage is an invention of the law with a long development it cannot be understood without some reference to its history. Human beings in organized societies economically based on property, i.e., individual or private ownership of wealth, are likely to invent similar devices for dealing with each other in their property relationships. So various, perhaps all, such civilizations have developed the mortgage in some form. We need concern ourselves, however, only with its development under English Common Law and Equity, and under statutory enactment on the foundation of that jurisprudence.

WHY SECURITY IS TAKEN

One man may supply another with money on the promise of the other to repay. This is a loan, and gives rise to a debt. But

the creditor, as a condition of making the loan, may require some assurance besides the debtor's promise that the debtor will repay. Failure to repay may arise out of bad faith. The debtor may not fulfil his promise although he may be able to do so. Society develops the means, the sanctions of the law, to compel the performance of the promise. Bringing these means to bear, however, may not be a swift process. And the debtor in possession of his property may place difficulties in the way. Besides, though the debtor may be willing to repay, he may not, when the day for performance arrives, be able to pay.

If at the time of making a loan the creditor is given possession of some of the property of the debtor, which the creditor is to surrender only on receiving payment of the debt, the creditor has taken a precaution against both bad faith of the debtor and inability of the debtor to repay. As long as the creditor has possession of the property, the debtor cannot conceal it from the search of the officers of the law seeking to seize it for the creditor's satisfaction. If the property is land, the debtor cannot conceal it, to be sure, but he can put other people in possession under a claim of ownership, to which their possession gives the color of truth. Or the debtor can sell the land and conceal the proceeds. Or he can dissipate the proceeds, and, though willing, be unable to repay.

CREDITOR IN POSSESSION UNDER EARLY FORM OF LAND SECURITY — VIF GAGE OR "LIVE" PLEDGE

Under the earliest English forms of land security the debtor gave the creditor possession of the land. The creditor in possession would be able to withstand the demands of any others claiming the property. As one form of security the *vivum vadium*, or *vif gage* or *live pledge* developed. The debtor conveyed the land, gave legal title, to the creditor and put the creditor in possession; so that the creditor had the use of the land. The creditor remained in possession and applied the rent, or profit, or usufruct, towards the satisfaction of the debt; he was accountable to the debtor for the amounts, until repaid, or until the debtor otherwise satisfied the creditor's claim; then, under the terms of the agreement between them, the creditor must reconvey the land to the debtor, and surrender possession to him. The right of the debtor to have all rents and profits applied

towards the satisfaction of the debt remained "alive"; his right to get his land back did not "die." And under this form of security the debt was not extinguished until it was paid.

There were variations in this security by possession of the land, as the Welsh pledge, under which the rents and profits were not applied towards the satisfaction of interest and principal, but were the interest on the debt be they great or small. This matter of applying the rents in compensation for the loan was affected with the mediaeval idea of the unconscionableness of interest. Money could not breed money. To have it do so was a monstrous abnormality. But mediaeval thought found no objection to having a share in an enterprise, or a right in land, and taking profits. We are not, for our purpose, concerned with such a variation, or, indeed with the vif gage as such, but only to show the mort - gage more clearly by contrast, and bring out the origin of the name.

THE OLD COMMON LAW MORTGAGE

Debtor and creditor, however, might agree that if the debt were not paid on or by a stated day, the "law day," then the debtor should no longer have any right to get his land back, but that the land should thereafter be the absolute property of the creditor, and the debtor be under no further obligation to pay. Such a form of the security was a *mortuum vadium*, *dead pledge*, or *mort - gage*. In this transaction the creditor kept the rents and profits, the usufruct, of the land, and accounted for them as payments towards the satisfaction of the debt. The right of the debtor to get his land back and the right of the creditor to be paid were capable of dying, and did die on failure of payment at the law day set by the bargain. If, on the other hand, the debtor paid on the law day, the creditor must reconvey the land to him. The situation was what lawyers call a conveyance with a condition, namely, that ownership was not to become indefeasible or absolute unless the debt were not repaid on the law day.

In the course of time the condition of the conveyance, that if the debt were paid on the law day the land should become the absolute property of the debtor again, originally inserted in the conveyance as an express "defeasance," was allowed to be self-operative, and it became unnecessary for the creditor actually to reconvey on receiving payment on the day. He simply let the debtor into possession again.

Under an old principle of our law it is the duty of a debtor to seek his creditor, if the creditor is within the Kingdom (or State), and make payment. What if the debtor were ready and willing to pay, but some accident prevented him from effecting payment on the law day? What if serious illness kept him at home, or on his way robbers fell upon him, or his horse and himself suffered injury which prevented him from making payment on time? What if the mortgagee tricked him into delay? Must he lose his land? The law said he must.

Such ill luck was his misfortune, and should not be permitted to vary the bargain to be made with his creditor. To be sure, as late as the time of Glanvil, who became Justiciar or chief law officer of England under Henry II (in 1180), or before the period which we are taking as our point of departure in tracing the course of the mortgage, the mortgagee was obliged to come into court and get a judgment to make the title absolute in him. But by the time of Edward I, with which, in effect, we are starting, a law writer, Britton, states clearly that the mortgagor had no right to get his land back after failure to pay the debt on the law day.

DEVELOPMENT OF EQUITY

But justice emanated from the King. It was not until six centuries after the Norman Conquest that it was clearly established that the King was as much bound by the law as his subjects. Since he was the source of justice, he could and on occasion did, in special instances, interfere with the operation of the rule of law applied by the courts. A petition from a subject showing that a strict application of the law in the special facts appearing in his case would work an unjust justice (to state a seeming paradox arising out of words used in different senses) appealed to the conscience of the King. He could, and on cause appearing adequate to him would, suspend the operation of the law. The King received petitions sitting in council, the small council, later called the privy council, as distinguished from the great council, which was to become Parliament; that is, he received them officially, in his kingly capacity, and acted with the benefit of the advice of the council.

Naturally the King's secretary, the Chancellor, Keeper of the Seal, came to receive petitions in the first instance, and brought them before the King in Council. From the Chancellor's office.

on behalf of the King as the source of justice, issued the original writs with which an action in the King's Courts began. The Chancellor could sort out petitioners, and to such as had sought relief for which there was a remedy provided in law, he could issue the proper writ. This action would let through to the King in Council only those proper petitioners for whom the law had no adequate redress. Since, too, the Chancellor was regularly a great ecclesiastic, and in his ecclesiastical function was "Keeper of the King's Conscience," it was particularly appropriate that matters of conscience should come to the King through him, and that the Chancellor's advice on them should have special importance.

So in this manner a wide variety of matters in which the rigidity of the law either provided no remedy, or worked a hardship, came before the King. It was natural that in the course of time the Chancellor should further screen out petitions, and himself pass on all relatively minor ones, letting through to the King only those of major importance. In the reign of Edward I an ordinance to this effect was issued. By the time of Edward III, the jurisdiction of the Chancellor had developed into a Court of Chancery, which did not follow the King in his journeyings about the realm, but sat permanently at Westminster; as, resulting from Magna Charta, did the King's law court of Common Pleas, sitting on disputes at law.

EQUITY OF REDEMPTION

This much of a bare suggestion of the origin of the Chancery or equity jurisdiction, doing the justice of equity where the justice of law was inadequate, is necessary to understand the development of mortgages. In connection with them the Chancellor came to interpose grace, suspending the operation of law, when payment on the law day was prevented through accident or other proper excuse, to allow a further opportunity to make payment. As time went on, equity extended its relief more and more fully to the mortgagor in default on the law day, and preserved to him a right to redeem his land from the mortgagee after the law day had passed. So a right to redeem, extended by equity after the law day, came to be known by the familiar phrase "equity of redemption." By the seventeenth century, it was established that the mortgagor had an equity of redemption

in all cases, from whatever cause his default arose, so that he did not have to show a reason. It was his *right,* so carefully protected that he could not contract it away.

FORECLOSURE

But it would be as inequitable to deprive the mortgagee permanently of the benefit of the security he had taken, as it was that the mortgagor should lose his land as a result of an accidental default. The mortgagee creditor is not to be held out of his law rights forever; or even until the running of a twenty-year period, on which he could claim that the right to redeem was barred by limitation of time. So equity developed the principle that the mortgagee, taking affirmative action, could come into court with a petition that, in the exercise of equity, the mortgagor's right to redeem should be cut off; and the court would decree that, unless the mortgagor redeemed by paying his debt within a specified reasonable period, he should be "forever barred and foreclosed" from his right.

Here we have the word which is familiar in the name of the proceeding now followed, "foreclosure." It will be noted, however, that the decree in equity, providing that the mortgagor be forever barred and foreclosed, so far simply restored the situation to the position it was in, before the development of the equity of redemption, on the passing of the law day without payment. Title became absolute in the mortgagee. But, further, besides becoming finally the unconditional owner, the mortgagee, in the course of the development of mortgage principles, gained an advantage.

In the condition of the law which has been taken as our starting point, the mortgagee had to accept the land in payment of his debt. With the development of the equity of redemption, in the interest of the mortgagor, there developed also the principle that the mortgagee's finally unconditional ownership of the land did not extinguish the debt, as it had formerly done. He could now still sue on the debt and recover any balance above the value of the land, which would be ascertained in the action on the debt. We see the mortgage getting further away from its original form of a conveyance subject to a condition, and moving very definitely to a form of fully recognized security for a debt.

The proceeding under which the mortgagor was forever barred

and foreclosed of his equity of redemption, leaving the mortgagee thereafter the unconditional owner of the land, came, in distinction from other methods of dealing with the situation, to be called strict foreclosure; and in some jurisdictions the mortgagee may still resort to this proceeding, though in various jurisdictions only under special circumstances.

DEVELOPMENT OF MORTGAGOR'S POSSESSION

In following one line of the development of the mortgage, the discussion has run ahead of the development along another line. We have seen that the mortgagor not only conveyed the land to the mortgagee, but that the mortgagee actually entered into possession at the time of taking the mortgage. Later it became customary to insert a covenant in the deed of conveyance that the mortgagor should remain in possession until the law day; so that the mortgagee had a right to possession only after the law day. Still later, however, such a covenant was not necessary to reserve to the mortgagor the right of possession. The fact that the mortgage deed was given to secure a debt became sufficient of itself to reserve possession to the mortgagor. Of course, on a strict foreclosure, with the mortgagor in possession, the mortgagee acquired the right of possession on the foreclosure, and the courts, if necessary, would assist him in exercising it.

MODERN FORMS OF FORECLOSURE

It may be seen that the remedy of the mortgagee by strict foreclosure, in the process of getting payment of the debt to him, may not be altogether satisfactory either to the mortgagor or the mortgagee. The mortgagee has the land, but if he does not regard it as having a value adequate to satisfy his claim, and sues further on the debt, the value of the land must be established to determine how far it goes towards the satisfaction of the debt. Opinions about the value of land often vary widely. On the other hand, assume that the mortgagor thinks the land worth much more than the amount of the debt. To be sure, he is given in effect an extension of time, within which, by paying, he can keep his land or get it back. But conditions for repayment may not be propitious; and it may be that the mortgagee will get land worth substantially more than the amount of the debt for which

it was security. The situation lacks precision, and other methods of foreclosure have come to be usual.

By the middle of the nineteenth century, with the assistance of statutes, the present common practice was defined. On the petition to foreclose, instead of setting a day within which payment of the debt must be made, or title to the land become absolute in the mortgagee, the court orders the mortgaged premises sold at public judicial sale by the sheriff, or a referee especially appointed by the court for the purpose, the proceeds to be applied towards or to the expense of the proceeding, and the satisfaction of the debt; and if more than sufficient to satisfy the debt, the surplus to be paid to the mortgagor, or to other persons, as second mortgagees or judgment lienors, found to be entitled. An advertised description of the premises, with the time of sale at a public place, that is, one open to all, is relied on to bring possible bidders; and in this way to save values in excess of the amount of the debt to the mortgagor unable himself to provide funds to redeem. Later pages will present a fuller description of the proceeding.

FORECLOSURE UNDER POWER OF SALE

With the development of foreclosure by judicial sale (sometimes called "informal foreclosure" in distinction from "strict foreclosure" which resulted in making absolute the title of the mortgagee), it became common to insert in mortgage instruments a provision giving the mortgagee a power of sale on default. Statutes regulate the exercise of such powers; and the mortgagee must follow strictly the statutorily indicated procedure.

LIEN THEORY OF MORTGAGE

So far, the mortgage appears as a transfer of title to the creditor, with a right of the debtor to get the title back (equity of redemption) on payment of the debt, until that right is cut off through judicial process by the creditor (foreclosure). In many American jurisdictions, however, the theory of the mortgage has changed, without substantially changing the results effected through the instrumentality, or even the general nature of the proceedings through which it operates. In such jurisdictions the mortgage is no longer regarded as effecting a transfer of the legal

title to the land, but as creating a lien on the land (as a chattel mortgage does on a chattel) to secure the debt.

With this introduction, which is hardly a sketch, but just a few lines intended to be suggestive of a picture, rather than presenting one, perhaps we can best consider the nature of mortgage security further by examining a form of modern mortgage. The form first presented represents a jurisdiction which continues the Common Law theory of a mortgage, and conveys the title to the land to the mortgagee. The second form represents a jurisdiction which has adopted the principle of the mortgage as a lien on the land.

One reading the form should remember that a corporation mortgage, which runs to one or two hundred printed pages, and secures an issue of $50,000,000 of bonds, is the same instrument, elaborated in contractual detail.

CONVEYANCE MORTGAGE

THIS INDENTURE, made the 29th day of August, in the year one thousand nine hundred and thirty-five,

BETWEEN JOHN SMITH and MARY SMITH, his wife, parties of the first part, and HENRY ROBINSON, party of the second part:

WHEREAS, the said John Smith, party of the first part is justly indebted to the said party of the second part in the sum of Five Thousand ($5,000) Dollars, lawful money of the United States of America, secured to be paid by his certain bond or obligation, bearing even date with these presents, in the penal sum of Ten Thousand ($10,000) Dollars, lawful money as aforesaid, conditioned for the payment of the said first mentioned sum of Five Thousand ($5,000) Dollars, lawful money as aforesaid, to the said party of the second part, his executors, administrators or assigns, on the 1st day of September, which will be in the year one thousand nine hundred and thirty-eight, and interest thereon, to be computed from the 1st day of September one thousand nine hundred and thirty-five at the rate of six (6%) per cent per annum, and to be paid on the first day of each March and September.

IT IS HEREBY EXPRESSLY AGREED, that should any default be made in the payment of the said interest, or of any part thereof, on any day whereon the same is made payable, as above expressed, or should any tax, assessment, water rent or other municipal or governmental rate, charge, imposition or lien be hereafter imposed or acquired upon the premises described in this mortgage, and become due and payable, and should the said interest remain unpaid and in arrears for the space of thirty (30) days, or said tax, assessment, water rent, or other

municipal or governmental rate, charge, imposition or lien, or any or either of them, remain unpaid and in arrears for the space of sixty (60) days, then and from thenceforth, that is to say, after the lapse or expiration of the said periods, as the case may be, the aforesaid principal sum of Five Thousand ($5,000) Dollars with all arrearage of interest thereon, shall, at the option of the said party of the second part or his legal representatives, become and be due and payable immediately thereafter, although the period above limited for the payment thereof may not then have expired, anything therein before contained to the contrary thereof in anywise notwithstanding; as by said bond or obligation, and the condition thereof, reference being thereunto had, may more fully appear.

NOW THIS INDENTURE WITNESSETH, that the said party of the first part, for the better securing the payment of the said sum of money mentioned in the condition of the said bond or obligation, with interest thereon, according to the true intent and meaning thereof, and also for and in consideration of the sum of one dollar, to him in hand paid by the said party of the second part, at or before the ensealing and delivery of these presents, the receipt whereof is hereby acknowledged, has granted, bargained, sold, aliened, released, conveyed and confirmed, and by these presents does grant, bargain, sell, alien, release, convey and confirm, unto the said party of the second part, and to his heirs and assigns forever,

ALL (description of property mortgaged)

TOGETHER with all and singular the tenements, hereditaments and appurtenances thereunto belonging or in anywise appertaining, with the reversion, remainder and remainders, rents, issues and profits thereof:

AND ALSO all the estate, right, title, interest, property, possession, claim and demand whatsoever, as well in law as in equity, of the said party of the first part, of, in and to the same and every part and parcel thereof, with the appurtenances, TO HAVE AND TO HOLD the above granted and described premises with the appurtenances, unto the said party of the second part, his heirs and assigns to his own proper use, benefit and behoof forever PROVIDED ALWAYS, and these presents are upon this express condition that if the said party of the first part, his heirs, executors or administrators, shall well and truly pay unto the said party of the second part, his executors or administrators or assigns the said sum of money mentioned in the condition of the said bond or obligation, and the interest thereon, at the time and times and in the manner mentioned in the said condition, according to the true intent and meaning thereof, that then these presents, and the estate hereby granted, shall cease, determine and be void.

AND THE SAID JOHN SMITH for himself, his heirs, executors and administrators, does covenant and agree to pay unto the said party of the second part, his executors, administrators or assigns, the said sum

of money and interest, as mentioned above and expressed in the condition of the said bond.

AND IT IS ALSO AGREED by and between the parties to these presents, that the said party of the first part shall and will keep the buildings erected, and to be erected, upon the lands above conveyed, insured against loss or damage by fire, by insurers, and in an amount approved by the said party of the second part, his executors, administrators or assigns, and assign the policy and certificates thereof to the said party of the second part; and in default thereof, it shall be lawful for the said party of the second part to effect such insurance, and the premium or premiums, paid for effecting the same shall be a lien on the said mortgaged premises, added to the amount of the said bond or obligation, and secured by these presents, payable on demand with interest at the rate of six (6%) per cent per annum, from time of payment of such premium or premiums.

AND THE SAID JOHN SMITH the owner of the lands above described, for himself, his heirs and assigns, does further covenant and agree to and with the said party of the second part, his administrators, executors and assigns, that they will not hereafter apply for any deduction by reason of any mortgage from the taxable value of the lands embraced in this mortgage.

AND IT IS FURTHER AGREED, that in case the said owner, his heirs or assigns, shall claim any deduction from the taxable value of the said lands in violation of this agreement, then and in that case this mortgage shall become and be immediately due and payable, and the amount of tax paid by the mortgagee shall be added to the principal of the debt hereby and recoverable therewith, with interest thereon from the time of payment.

IN WITNESS WHEREOF, the said parties of the first part have hereto set their hands and seals the day and year first above written.

Sealed and Delivered in
the Presence of

THOMAS BROWN

JOHN SMITH (L. S.)
MARY SMITH (L. S.)

STATE OF NEW JERSEY, } SS.:
COUNTY OF ESSEX.

BE IT REMEMBERED, that on this 29th day of August, in the year one thousand nine hundred and thirty-five before me personally appeared JOHN SMITH and MARY SMITH, his wife, who, I am satisfied are the grantors in the within Indenture of Mortgage named, and I having first made known to them the contents thereof, they did acknowledge that they signed, sealed and delivered the same as their voluntary act and deed, for the uses and purposes therein expressed.

or within seven (7) days upon request by mail will furnish a statement of the amount due on this Mortgage.

8. That the Mortgagor warrants the title to the premises.

IN WITNESS WHEREOF, this Mortgage has been duly executed by the Mortgagor.

In Presence of: JOHN SMITH (L. S.)

THOMAS BROWN

STATE OF NEW YORK,
COUNTY OF NEW YORK. } SS.:

On the 29th day of August, nineteen hundred and thirty-five, before me came JOHN SMITH to me known to be the individual described in, and who executed the foregoing instrument, and acknowledged that he executed the same.

ALBERT DIXON

Seal of Albert Dixon Notary Public State of New York	Notary Public State of New York County of New York, New York County Clerk's No......... Register's No. .... Commission expires.. ....19........

FORM OF BOND SECURED BY MORTGAGE

KNOW ALL MEN BY THESE PRESENTS, That JOHN SMITH of No........ Broadway, Borough of Manhattan, City, County and State of New York, is held and firmly bound unto HENRY ROBINSON of No........ Riverside Drive, Borough of Manhattan, City, County and State of New York, in the sum of Five Thousand ($5,000) Dollars, lawful money of the United States of America, to be paid to the said HENRY ROBINSON, his administrators, executors or assigns: for which payment, well and truly to be made I bind myself, my heirs, executors and administrators, firmly by these presents. Sealed with my seal, Dated the 29th day of August, one thousand nine hundred and thirty-five.

THE CONDITION of the above obligation is such, that if the above bounden JOHN SMITH, his heirs, executors or administrators, shall well and truly pay, or cause to be paid, unto the above named HENRY ROBINSON, his executors, administrators or assigns, the just and full sum of Five Thousand ($5,000) Dollars on the first day of September, 1938, with interest thereon to be computed from the first day of September, 1935, at the rate of six (6%) per cent per annum payable the first day of March, 1936, and semi-annually on the first day of each September and March thereafter, the said sum being secured by mortgage of even date herewith, without any fraud or other delay, then the above obligation to be void, otherwise to remain in full force and virtue.

AND it is hereby expressly agreed that the whole of the principal sum

shall become due at the option of the above named HENRY ROBINSON, his legal representatives or assigns, after default in the payment of any instalment of principal or of interest for thirty (30) days or after default in the payment of any tax or assessment upon the premises described in the mortgage accompanying this bond for sixty (60) days after notice and demand.

AND IT IS ALSO AGREED, that the said party of the first part will keep the buildings on said premises insured against loss by fire for the benefit of the mortgagee therein. And the above named HENRY ROBINSON, his legal representatives and assigns shall also be at liberty, immediately after any such default or any default in the payment of any amount due on this bond, upon a complaint filed or any other proper legal proceedings being commenced for the foreclosure of the mortgage accompanying this bond, to apply for, and shall be entitled, as a matter of right and without regard to the value of the mortgage premises as security for the amounts due upon said mortgage or this bond, or to the solvency of any person or persons liable for the payment of such amounts, to the appointment by any competent court or tribunal of a receiver of the rents and profits of the premises described in said mortgage, with power to lease the said premises or such part thereof as may not then be under lease, and with such other powers as may be deemed necessary, who, after deducting all proper charges and expenses attending the execution of the said trust, as receiver, shall apply the residue of the said rents and profits to the payment and satisfaction of the amount remaining due on said mortgage, or to any deficiency which may exist after applying the proceeds of the sale of the said premises to the payment of the amount so remaining due, including interest and the costs of the foreclosure and sale.

JOHN SMITH (L. S.)

Sealed and Delivered
in the Presence of

THOMAS BROWN

STATE OF NEW YORK, } SS.:
COUNTY OF NEW YORK. }

On the 29th day of August, nineteen hundred and thirty-five, before me came JOHN SMITH, to me known to be the individual described in, and who executed, the foregoing instrument, and acknowledged that he executed the same.

ALBERT DIXON
Notary Public State of New York
County of New York, New York
County Clerk's No.... ....
Register's No.. ... .
Commission expires................19........

Seal of
Albert Dixon
Notary Public
State of New York

CHAPTER XVII

Mortgage — Relationship of the Parties

The forms of mortgage begin by stating the parties, naming the mortgagor and the mortgagee. It will be noted that in the first form a wife joins with her husband as mortgagor. This is for the purpose of cutting off her dower. Under the Common Law, and still in most of the States, a wife is entitled on the death of her husband to an interest (usually one-third for her life) in all the real estate owned by her husband during their marriage. Since she may not survive her husband, this is called an inchoate right as long as he lives. But he cannot convey or mortgage his real estate free from this right without her consent; and to evidence this consent to the grantee or mortgagee she must join in the deed or mortgage. The second form represents an exceptional jurisdiction in the United States which, by statutory enactment, has abolished the right of dower. It is assumed that the husband acquired the land after the enactment of the statute; otherwise the wife's dower would have attached, and she would have to join.

PURCHASE MONEY MORTGAGE

Assume, however, that A is buying a house and lot of B, and under the contract between them A has agreed to pay a total price of $7500 by $2500 in cash on delivery of the deed, and immediate delivery to B of a bond for the balance of $5000, and a mortgage on the house and lot to secure the bond. Such a mortgage is called a "purchase money" mortgage, i.e., it is given to secure payment of part of the purchase price of the mortgaged premises. It is not necessary for the wife of A to join in such a mortgage in order to cut off her dower. Though such a result is a little difficult to justify under strict logic of the Common Law

of real property, the real situation is that A had agreed in effect to buy a house and lot subject to a mortgage. Under the agreement there was in effect an equitable mortgage on the premises when A received the deed from B, which A's instrument converts into a legal mortgage. The dower of A's wife attaches however to his equity of redemption.

CORPORATIONS TO AVOID DOWER AND USURY

Of course the matter of dower has no relevancy to the corporate situation. But in discussing the individual mortgage, as containing all the essential elements of the corporation mortgage, we cannot avoid mentioning dower. Men often form corporations to own their real estate for the purpose of avoiding the dower complication. Another reason is that some usury statutes do not apply to corporations; others permit them to pay a higher rate of interest than individuals.

THE DEBT

Both forms state the amount of debt secured, and refer to a further instrument (the bond), representing the debt and given to secure it. The first form refers to a bond in a "penal sum," and the amount named is twice the amount of the actual indebtedness. This is to cover amounts over and above the amounts of principal which may become due on the obligation, as accruals of interest, premiums paid for insurance, taxes which the mortgagee may have been obliged to pay to protect his security, costs of foreclosure, etc. In actual result there is no difference between the first and the second form. The mortgagee cannot in either case collect more than the amount due him, the principal and interest, with such allowable additions as have been indicated, for which he is merely reimbursed, and these he is entitled to under either form.

In both the forms the mortgage is given to secure an indebtedness evidenced by a bond, that is, a formal instrument under seal containing the promise to pay, but not in the form of a negotiable instrument. But the separate promise to pay the debt may be contained in an ordinary note, negotiable in form or not. For our purpose we do not need to delay for such distinctions as may arise out of this difference in form — such as the

principle of the security following the debt and its effect in case a negotiable promissory note evidences the debt; and the longer period of the statute of limitations, usually twenty years on the instrument under seal, the bond, as against a period of usually six years in the case of the unsealed instrument, the promissory note, after the running of which the lapse of time may be pleaded in bar of collection. The promise to pay may be on demand as well as at a fixed time; and in some jurisdictions, as in New England, it is customary to evidence the debt by a demand note. Indeed, it is not necessary to have a separate paper evidencing the debt. A promise to pay may appear in the mortgage itself and will be sufficient. But it is regular practice to give a separate paper to evidence the debt, and such a practice shows clearly the nature of the entire transaction, that a debt has been created, and the debt is secured by a mortgage on land.

DESCRIPTION OF PREMISES MORTGAGED

In the forms presented a description of premises mortgaged has been omitted. Only such statement as will clearly identify the premises is absolutely required; but it is customary to present an accurate description by metes and bounds.

HABENDUM

Under the first form, presenting the Common Law theory of a mortgage, the mortgagor "grants" the premises to the mortgagee "to have and to hold" them. This is precisely the language used in a deed of absolute conveyance.

DEFEASANCE

But the subsequent provision clearly states the consequence of the grant being given to secure a debt; namely, that if the debt is paid in accordance with the tenor of the bond, the estate granted shall cease, determine and be void. We will later consider the way in which a recording system complicates the operation of this "defeasance" provision.

Representing the lien theory, the second form does not contain a "grant" of the land with a defeasance provision, but simply states that "the mortgagor hereby mortgages to the mortgagee" the premises described.

COVENANTS

A covenant is a promise under seal (at one time the only promises cognizable at Common Law). And we find in the mortgage forms various promises of the mortgagor to the mortgagee. Let us follow those contained in the second form.

(1) The first contains the same promise as in the bond, to pay the debt secured by the mortgage. As already stated this promise in the mortgage would be sufficient without the separate instrument containing it; but even though the mortgagee has this promise in the mortgage, he regularly also takes a bond or note containing it. And in a corporate mortgage, with the group lender, each member of the group wants something to evidence the amount of his share in the total loan; just as a stockholder wants a certificate of shares to evidence his interest in the corporate enterprise. Though, as we shall see, there is only one mortgage (made to a trustee) there are many bonds: i.e., 10,000 bonds for $1000 each may evidence a corporate debt of $10,000,000.

(2) If the mortgaged land is improved with buildings, a fire would impair the security. The mortgagee has an "insurable interest" in the premises and could take out insurance to protect himself. But his payment of the premiums would diminish his net return from his investment, unless by agreement the mortgagor was to reimburse him, which would involve further accounting between the parties. The first form of mortgage contains an express provision that, if the mortgagor fails to keep the premises insured for the benefit of the mortgagee, the latter may take out insurance and add the premiums to the mortgage debt. But by the law of the jurisdiction of the second form, it is the right of the mortgagee to do so without express agreement. In fact, it may be said generally that by force of the law and equity development of the security, by judicial interpretation and by statutory enactment, the mortgage implies vastly more than it states in expressed terms.

To assure such insurance, the mortgagee requires that he have possession of the policy or policies. If there are existing policies for the benefit of the mortgagor, customarily he procures from the insurance company the attachment to policies of sufficient amount to protect the mortgagee, of riders making the loss payable to the mortgagee, and delivers these policies to the mortgagee.

(3) Since the mortgagor remains in possession of the premises, he could impair the security by the demolition or removal of buildings. The third covenant expressly stipulates that he shall not. Presumably in the jurisdiction of the first form, reliance is placed on the law as adequately protecting the mortgagee against "waste," without the insertion of any such express provision.

(4) The fourth covenant contains what is called an acceleration of maturity of principal. Since, without such a provision, the mortgagee, on default of interest before the due day of the principal sum, could foreclose only for the interest in default, a highly unsatisfactory situation, this covenant is most important. Here are stated the "events of default" which will cause the principal to become due before the named date.

(5) Under the Common Law mortgage, as has been seen, after it became the right of the mortgagor to remain in possession of the premises until the debt fell due, if then the mortgagor failed to pay his debt the mortgagee had a right to take possession. The fifth covenant in some measure provides for a corresponding effect. It does not become operative, to be sure, immediately on the default, but only on beginning the foreclosure. And the possession of the receiver is not the possession of the mortgagee. The receiver is not the agent of the mortgagee, but the agent of the court.

Under the order of the court appointing the receiver he collects the rents; and after the payment of taxes, and costs of care of the premises, he holds the money to be applied with proceeds of sale in foreclosure to the satisfaction of the mortgage debt. Such a remedy is valuable. Without it, a mortgagor, continuing in possession, might be receiving substantial income from the mortgaged premises and applying it in other directions, letting even taxes on the land continue in default. In the jurisdiction of the form containing this covenant, the mortgagee without this express provision does not have a right to the appointment of a receiver unless he shows that the security is inadequate. With the covenant he has a right to a receiver without showing anything about the value of the premises or the danger of his security. Some jurisdictions still preserve the right of the mortgagee to take possession on default.

(6) One grave danger to the mortgagee's security, indicated in the fourth covenant, appears again in the sixth. The importance of the public welfare gives taxes and other public charges a

precedence over all considerations of private interest. On assessment for taxes, and levy thereof, after the prescribed statutory period they become a lien on the premises, which may be sold for their satisfaction. So the accrual of taxes is a constant menace to the security of the mortgagee. In this sixth covenant the mortgagor expressly promises to pay taxes, etc., and provides that if he does not the mortgagee may. Payment by the mortgagee increases the debt secured by the mortgage.

Provisions about taxes in the first form indicate another tax problem in connection with mortgages. Both mortgagor and mortgagee have an interest in the land. The law of a jurisdiction can provide for taxing these interests separately. The mortgagee may feel that it is necessary, or desirable, to guard against a diminution of his net income resulting from a separate taxation, and require the mortgagor to give him a protective covenant. Indeed, though the mortgagor pay the tax on the entire value of the land, the jurisdiction can still tax the mortgagee on his property in the debt. In New York, when mortgagees were fearful that changes in the taxation of personal property might have the result of increased taxation on mortgage debts, it became customary for them to protect themselves by requiring a covenant that, if such increased taxation were enacted, they might elect to call the entire debt due and payable.

(7) It may be that the mortgagee will later want to assign his mortgage; that is, liquidate his investment by selling it to someone else who wants to make such an investment. Since the bond is not a negotiable instrument, if the mortgagor has made part payment, the assignee of the mortgagee will be able to collect only the amount unpaid; and this even though he has no knowledge of part payment, and the face amount of the bond is not yet due according to its terms. So the prospective assignee will not buy the mortgage unless he is sure for just what he will be able to enforce payment against the mortgagor. He will require what is known as an estoppel certificate, a statement from the mortgagor admitting the amount due, which he will not thereafter be allowed to dispute with the assignee. Under the provisions indicated, the mortgagor covenants to give such a statement.

Covenants (8) and (9) are self-explanatory. In the case of a purchase money mortgage covenant (9) is unnecessary, for presumably the mortgagee by his deed has warranted the title to

the mortgagor; and in any event the mortgagor would not warrant back to the mortgagee any better title than the mortgagee has warranted to his purchaser.

As seen from the two forms of mortgage presented, covenants vary among jurisdictions to fit the legal problems arising under the state of the law in each. And the parties to the mortgage may have special results they wish to accomplish, which they may by special covenants, provided such covenants do not destroy the essential character of the instrument as mortgage security for a debt.

ACCEPTANCE

Though the mortgagor and mortgagee are both parties to the mortgage, only the mortgagor executes the instrument. Delivery transfers the title, or creates the lien, as the case may be. But there can be no real delivery unless the mortgagee (or an agent for him) voluntarily takes the paper into possession as creating the mortgage. Though he does not execute it, his acceptance signifies assent to its terms.

SIGNATURES AND SEALS

A mortgage takes effect when it is signed, sealed, and delivered. If it conveys title, it is a deed, and must satisfy the requirement for a deed of being an instrument under seal. And jurisdictions which have adopted the lien theory statutorily require a seal.

ACKNOWLEDGMENT

Appearance of the mortgagor before a public officer authorized to take acknowledgments of deeds, for the acknowledgment by the mortgagor that he did execute the mortgage instrument, establishes evidence of such execution. Such an acknowledgment, formally stated on the paper by the officer before whom it was made, is necessary to enable the mortgage to be recorded in the proper public record office.

During the long period of the development of the mortgage there was (speaking broadly) no recording of conveyances and no provision for it. Each landowner held his deed, and former deeds evidencing his claim of title, and when he sold his land, passed them on to his grantee. Possible complications are rather obvi-

ous. The deeds might be lost or destroyed. A grantor might not be selling an entire parcel, but only part, and would not be willing to give up his evidence of title to the part he still owned. On the death of an owner with more than one heir, not all the heirs could have the old deeds.

RECORDING

So a system of recording conveyances of land in a public record office has developed. A grantee or a mortgagee can take the instrument which has been delivered to him to this office and have it recorded, and this record, which is open to the world, discloses the evidence of ownership or of mortgage claim. The mortgagee or the grantee is not obliged to put his instruments on record in order to acquire his rights. He got them when the instrument was delivered to him.

But the law has worked out principles which bring pressure on him to record. Delivery of a conveyance transferred title. Before the adoption of a recording system, if the grantee got title no subsequent conveyance by the grantor could be effective; the grantor then had no title to convey. But could the grantee on receiving his deed feel sure that he had title? If the grantor had previously conveyed to someone else, the second grantee got nothing but his ineffective deed.

Under the recording system, if the first grantee presents his deed for copying in the public record, no subsequent grantee takes anything by his deed. If the grantor gives a deed to a second grantee before the first grantee has put his deed on record, the situation is unchanged. The first grantee has title. But if the second grantee has taken his deed in ignorance of the earlier conveyance, taken it, that is, in good faith, and presents it for recording before the first grantee presents his deed for recording, the second grantee gets the title.

Diligence in recording is rewarded. As long as the two claimants were in an equally meritorious position, each acting in good faith, believing that he was getting title, the priorities in time of delivery govern. In the viewpoint, under a recording system, of the public interest in having conveyance on record, so that ownership may be ascertained through the chain of title, the two claimants are not equally meritorious, if one presents his conveyance for record before the other. These principles apply to both deeds and mortgages. If a mortgagor fraudulently delivers two mort-

gages, representing each to be a first mortgage, the person who gets the later delivery in good faith without notice and nevertheless first records his mortgage will have the prior claim on the mortgaged premises; and the person who got delivery first, will have the second claim.

MORTGAGOR MAY SELL

After the owner of land has mortgaged it, he still remains in possession. Under the conveyance theory he still has his equity of redemption, along with his right of possession at least until default. And under the lien theory, he likewise has a right of possession, title, and a right to discharge the lien, in which he will be protected after the due day of the debt, just as the conveying mortgagor has his equity of redemption. Indeed, the right of the lien mortgagor to discharge the lien by payment after the due day, until the mortgagee by appropriate proceeding cuts off the right, is commonly called his equity of redemption, though a misnomer; and the proceeding by which the right is cut off is a foreclosure, just as in the case of a conveyance mortgage.

Since the mortgagor has all these rights, he is still called *owner* of the property. He can sell and transfer these rights to another. On so doing he is said to have sold the land, even though, in the case of a mortgage by conveyance, he cannot transfer title to the land, but only the right to redeem. In the case of a lien mortgage he actually does sell, that is, conveys title.

Or the mortgagor can give a second, a third, and still further mortgages. Under the conveyance theory the second mortgage is a conveyance of the equity of redemption, and his third mortgage is a conveyance of his equity to redeem his equity of redemption, and so on. Of course, on a lien theory, his successive mortgages are simply successive liens.

In any case of sale the mortgagor sells the land subject to the existing mortgage or mortgages. Let us make the situation concrete. A mortgaged his land to B, to secure B in the payment of $5000 loaned by B to A, for which A gave his bond. Later A sold the premises to C, and conveyed by deed, which recited that the land was *subject to* the mortgage of $5000 to B. In accordance with the contract between A and C, when A delivered the deed C paid A $2500 in cash.

What now is the relationship between A, B, and C?

PURCHASER MAY TAKE SUBJECT TO THE MORTGAGE OR MAY ALSO ASSUME IT

A has not agreed with C that he, A, would pay his debt to B and discharge the mortgage. But if the stipulated interest and principal of the debt are not paid, B will exercise his right to foreclose. Since C has not acquired the right to have A pay the mortgage, if C wants to hold the land C must pay it, interest and principal. When C contracted to buy the land he considered it worth $7500. He paid $2500 to A, and to keep the land must pay $5000 to B. But if C later should not be able to pay B, or should choose not to pay B, C is under no obligation either to A or B to pay. C nowhere made any agreement to pay.

Though B cannot prevent A from selling the premises, B still holds A's bond, and A must pay B if C does not. If C fails to pay the mortgage, either one of two things may happen. B may foreclose the mortgage. Assume that B does, and receives $3000 from the sale of the land. A still owes B the balance of $2000 due on the $5000 debt. Or A may pay B the $5000. If he does he steps into B's shoes of the right to foreclose. If on A's foreclosure the land realizes $3000, that ends the matter. C has lost his land in either case, and A is out the $2000 deficiency. If the land, however, should sell for $6000, C is entitled to the $1000 above the mortgage claim.

Suppose, as a result of the negotiations between A and C for the sale of the house and lot, C had agreed with A that he, C, would pay the debt of A to B. Then the deed from A to C will not only recite that the premises are subject to the $5000 mortgage, but it will contain the stipulation that C *assumes* and will pay the mortgage.

Under the theory of the law, the contract for the sale is merged in the conveyance; that is, essentially, the conveyance is taken in fulfillment of the contract. However, C accepted the conveyance, which A alone executed. And C is bound by its stipulation that he shall pay. That settles the rights between A and C. But B still has A's promise to pay; and he cannot now be compelled to take the promise of anyone else in place of A's promise. B has A's promise to pay the $5000, and A has C's promise to pay this $5000 to B. As between A and C, C must pay; as between A and B, A must pay if C does not.

Just how the rights of A, B, and C will be settled becomes com-

plicated by differences in the procedure of various jurisdictions. C should pay A. But C has made no promise to A. Some jurisdictions have worked out a procedure applicable, not to mortgages alone, but to contracts generally, so that if A owes B, and C contracts with A to pay A's debt to B, then, to avoid two law suits to settle a matter, B may sue C in spite of the fact that there is no contract between B and C.

In such jurisdictions the mortgage problem presents no difficulty. In foreclosure B can, of course, hold C for a deficiency between the amount derived from the sale of the land and the amount of the debt. But, in one manner or another, all jurisdictions work out as the essential rights of the parties; that on C's assumption of the debt, C becomes the party primarily liable, and A only secondarily liable. And if there is a series of sales of the mortgaged premises, with the successive purchasers assuming the mortgage, the purchasers are liable in the inverse order of the transactions.

When A sells the land to C, if B is willing to release A from A's personal liability on his bond, of course B can do so. Then B can look only to the value of the land for payment; or to this value, and such rights as he may acquire on C's assumption of the mortgage. But ordinarily there is no reason why he should release A, and he does not. If B is willing to release A, on C's assumption of the mortgage, it would be better all around, as creating a clearer, simpler situation, to discharge the mortgage made by A to B, and have a new mortgage made by C to B.

But if a second mortgage has been placed on the premises, it would become the first immediately on the discharge of the mortgage from A to B. This situation would prevent C from giving a first mortgage to B, unless the second mortgagee consented to subordinate his mortgage to the new first mortgage. Sometimes such subordinations are covenanted for in the second mortgage.

MORTGAGEE MAY ASSIGN THE MORTGAGE

We have just considered the right of the mortgagor to sell his ownership of the premises, and the consequential rights of the parties involved. The situation of the mortgagee in dealing with his property, the debt due him and its mortgage security, is much simpler. Nothing is due to the mortgagee but the payment of money; and he can assign his right to receive this money, and with

it the mortgage security. On receiving notice of the assignment, the mortgagor must make his further payments to the assignee. Delivery by the mortgagee of the bond and mortgage to his assignee, together with the instrument of assignment, protects the assignee against a subsequent purported assignment by the mortgagee; but as a further protection, and as notice to the world of his mortgage interest in the premises, the assignee may record his assignment in the public record office, just as the mortgage itself is recorded there.

VOLUNTARY PAYMENT OF THE MORTGAGE DEBT

As we have seen, originally under the conveyance mortgage, when the mortgagor paid his debt the mortgagee must reconvey the premises. Then we saw that the insertion of the defeasance clause in the mortgage made the retransfer of title self-operative. And so it might have remained but for the development of the recording system. Now, though payment be made, the record still indicates that the premises are mortgaged. The record must be cleared. In a conveyance jurisdiction the mortgagee, in receiving payment, will deliver to the mortgagor a quit-claim deed, or equivalent instrument, transferring to the mortgagor all the title which the mortgagee held; or, in a lien jurisdiction, deliver to the mortgagor an instrument evidencing "satisfaction" of the mortgage. The mortgagor places the instrument on the record in the office in which the mortgage is recorded.

ENFORCING PAYMENT BY JUDICIAL PROCESS — FORECLOSURE

If the mortgagor does not voluntarily fulfil his promise to pay, generally the mortgagee might sue on the bond. But he regularly finds it more advantageous to pursue his remedy of foreclosure, in which, by appropriate process, he may procure a deficiency judgment against the mortgagor for any amount of the debt which the proceeds of the sale of the premises do not pay. Since foreclosure proceedings vary from jurisdiction to jurisdiction enough to make an endeavor at generalization inexpedient, they will be outlined for a particular jurisdiction. The sketch, however, will sufficiently indicate the substance of the process generally.

NOTICE OF PENDENCY OF FORECLOSURE

The attorney for the foreclosing mortgagee files in the record office a notice of the pendency of an action to foreclose. This is notice to the world, and will make any dealing with the property ineffective to interfere with the foreclosure.

SUMMONS AND COMPLAINT PARTIES — OBTAINING JURISDICTION

Since the foreclosure outlined is that of a lien jurisdiction, the statutory proceedings, though essentially equitable, take the form of an action at law rather than of a petition in equity. The complaint, stating the essential facts about the mortgage and the default, must name as parties defendant all whose interests in the mortgaged premises are to be cut off. Of course the owner (and his wife if in a jurisdiction in which a wife has dower) and any subsequent mortgagees must be included. The complaint must also name as parties defendant any people who have acquired judgment or other liens subsequent to the mortgage being foreclosed, and any tenants who acquire leases subsequent to the mortgage, if it is desired to cut off their leasehold interests.

Jurisdiction of the court must be obtained over such persons by serving them with a summons and a copy of the complaint, or by their voluntary appearance in the proceedings. If necessary parties are outside the State, the court may authorize substituted service by advertisement and mailing. Other persons may be proper, though not necessary parties, as a mortgagor who has sold the premises to the present owner, or other intermediate owners who had assumed the mortgage, in order that on obtaining a deficiency judgment it may be good against them. Mortgagees who are prior to the mortgage being foreclosed may be made parties.

APPLICATION FOR ORDER TO COMPUTE — ORDER OF REFERENCE

Assuming that no answer setting up a defense to the complaint is made, the attorney for the mortgagee next prepares and presents an application for an order to compute. This furnishes evidence that by service on, or appearance of, the parties, the court has jurisdiction over them, and that their time to answer has ex-

pired. It must show the amount of the debt due, and any other facts that may be necessary as a basis to continue the proceedings.

On this application the court will make an order appointing a "referee to compute." It is his duty, after notice to the parties, to take evidence and ascertain the amount of principal and interest due on the mortgage.

When the referee has taken the evidence, he reports his findings to the court.

JUDGMENT OF FORECLOSURE

After the filing of this report, then, on notice to the defendant parties, the plaintiff applies for judgment of foreclosure and sale. This judgment describes the property, and appoints a referee to sell it, or directs the sheriff to sell it, and execute and deliver a deed to the purchaser. The judgment will also direct the disposition of the proceeds of the sale to or towards payment of the costs of the proceeding and satisfaction of the mortgage debt. If the complaint asked for a deficiency judgment, the order of the court will also give it against those defendants who are personally liable on the debt. The judgment also designates the newspapers in which notice of the sale shall be published.

The fact that the sale is a public sale open to all possible bidders is relied on to procure a fair price.

SALE

The advertisement of sale is inserted the required number of times over the required period. Then the referee to sell (or sheriff, as the case may be) sells the property. If the mortgage being foreclosed is a junior mortgage, the sale will be subject to prior mortgages, unless a prior mortgagee on default in his mortgage has joined in the application to foreclose. The sale is at public auction to the highest bidder, who is given a reasonable opportunity to examine title. Assuming that he finds no objections to the title, he must then pay the purchase price, and accept a deed which the referee or sheriff executes and delivers to him.

Ordinarily the mortgagee buys at his own sale. He would not bid more than the amount of the mortgage, because that is all he has a right to get of the proceeds of a sale. It is seldom that he would want to own the property at a cost in excess of the amount of the mortgage. He wants only to get paid the sum due him.

How high he will bid depends on his estimate of the probabilities of realizing on his claim. If the mortgagor were good for a deficiency judgment up to the amount of the mortgage, the mortgagee would not bid at all.

However, a mortgagor able to respond to this extent would not have defaulted, but would have protected himself against loss of an asset. So the mortgagee will not sacrifice values in the property that he cannot get made up otherwise. He is in an advantageous position in bidding. Up to the amount of the mortgage, he will have to pay in cash only enough to cover the costs of the sale. The rest of his bid he can pay with the bond of the mortgagor. Anyone else bidding will have to pay the whole price in cash. When we come to the topic of corporate reorganizations, we will see the importance of this in the corporate situation.

Under the conveyance theory of the mortgage, the mortgagee has title. The sheriff may be regarded as his agent to execute the deed to the successful bidder. Since the person making the sale receives the purchase money, and may have a duty to persons other than the mortgagee with respect to this money, it would not be appropriate that the mortgagee himself should sell and give the deed.

SURPLUS MONEY PROCEEDINGS

It may conceivably happen that the referee to sell has money left in his hands after paying the costs of the foreclosure, and satisfying the foreclosing mortgagee. Then the parties who have been foreclosed, junior lien claimants, junior mortgagees, the owner, may appear in surplus money proceedings to determine just how the surplus funds shall be allocated and paid. This may involve an ascertainment of the value of the dower interest of the wife of the owner of the property which has been foreclosed.

CHAPTER XVIII

Corporation Mortgages

Since the beginning student of finance, untrained in the law, is likely not to think of large issues of corporation mortgage bonds in the essential terms of a $5000 mortgage on a house and lot, the fact that the two things are in substance the same can hardly be overemphasized. But in effect the 5000 bonds for $1000 each delivered by Corporation X, as an issue of $5,000,000 of bonds secured by mortgage on the tangible assets of the corporation, are the same substantial thing as the one bond for $5000 delivered by A to B secured by a mortgage on A's house and lot. The apparent differences are simply the result of devices to enable the aggregate corporate mortgage debt to be represented by 5000 separate debts of $1000 each with the same security. They are devices to enable a group (of creditors in this case) to act as if the many wills were but one will.

TRUST TO SEPARATE LEGAL TITLE TO SECURITY FROM BENEFICIAL INTEREST IN IT

For this purpose another development of equity is utilized. It is called a trust. We have seen possession and use separated from legal title in the conveyance mortgage, which vests title in the mortgagee and leaves the mortgagor in possession and enjoyment of the property. Such a separation takes place in any loan of a chattel. But by a trust, legal title and possession may be joined in one person, though the beneficial use or enjoyment is in another.

As a common illustration of this, A by will leaves his estate to B, for B to pay the income to A's widow, C, for her life, and on her death to divide the principal among the children of A. This is a testamentary trust, with B as trustee, and the widow as beneficiary for her life. B has the legal title to the assets of the estate, and possession of them; but C has the benefit. By a declaration

of trust A, while he was alive, might have given his estate to B to pay the income to A so long as A lived, and on A's death to pay the income to C, if she should survive A; and on the death of both A and C to divide the principal among their children.

Under a trust, then, the legal title and possession are in one and beneficial interest in another. Of course the word "title" is only a kind of law shorthand to indicate that certain relationships exist rather than other relationships. It is not, like possession and benefit, something that can be perceived. Gellett Burgess never saw a purple cow, and no one ever saw or will see a title. Yet laymen are familiar enough with the word and have some substantial understanding of what it means.

Courts of law, as distinct from those of equity, recognize only the holder of the legal title. But it would be inequitable for the person holding legal title, under the circumstances indicated, to refuse to pay the income to the persons designated by the one who gave the property to B for the purpose of having B pay the income to them. Such conduct on the part of B would be unconscionable. And, as we have seen equity relieving the mortgagor from forfeiture under unconscionable circumstances, so we see equity intervening in such circumstances as those just indicated, and bringing its sanction to bear to compel B to pay the income to those who should receive it.

For the purpose of securing a bond issue by a mortgage, a corporation makes the mortgage to a trustee. Since the mortgage itself (under the conveyance theory) already separates possession from title, we have, by a mortgage conveyance to a trustee in trust, a separation of title from the benefits intended to be derived from it. The mortgagor corporation continues in the possession and use of the mortgaged property; but the trustee, to whom the mortgage is made, holds the mortgage for the security of those who have made a group loan to the corporation.

FORMATION OF THE MORTGAGE SECURED CREDITOR GROUP

In actual practice the creditor may not become a group until a time later than that of the actual advancing of the loan. That is, an investment banker may have contracted to advance $5,000,000 to the corporation under an agreement that the corporate debt be secured by a mortgage to a trustee on the corporate assets. If the

banker were making an investment for himself, intending to keep it until maturity, he could, as we have seen for a $5000 mortgage on a house and lot, have taken a single bond for $5,000,000 secured by a mortgage to himself. But the banker is not an investor placing out his own money for the purpose of income. He is a merchant of credit, selling at retail loans which he buys at wholesale, and making a profit by his merchandising. He contracts with the seller to have the goods put up in retail packages, 5000 of $1000 each, instead of one $5,000,000 bond, which in that form is not merchandisable.

So the banker, presumably with the assistance of bank loans to him for the purpose of the transaction, pays the corporation $5,000,000, less such discount as agreed upon; the corporation delivers the bonds to the banker, and at the same time delivers its mortgage to the trustee. Then, selling the bonds at retail, the banker creates the group creditor of the corporation.

PARTICIPATION CERTIFICATE LOANS

The banker might have provided for retailing by having a $5,000,000 bond made by the corporation to the trustee, and delivered to the trustee with the mortgage. In that case the corporation would pay the interest to the trustee, and the banker would have arranged to have the trustee issue to him 5000 certificates, each representing an equal interest in the bond and mortgage held by it, and containing the trustee's promise to pay to each holder of a certificate one five-thousandth part of the interest and principal received by the trustee from the corporation. That is, this promise would not contain any promise of the trustee absolutely to pay interest and principal, but only to pay when, as, and if received.

What essential difference would there be between the corporation's delivering to the banker 5000 of its bonds, each containing the corporation's promise to pay $1000, and its delivering to the trustee one bond promising to pay the trustee $5,000,000, which the trustee promises to divide among the holders of its certificates? We have seen in connection with our consideration of the individual mortgage that the bond as representing the debt, and the mortgage as creating the security, are separate things; and that the mortgagee may (generally), if he wishes, sue on the bond as such without resorting to the mortgage security.

When the corporation issues 5000 bonds each holder correspondingly has a debt which he can sue on independently of other holders of corresponding bonds. He can to this extent exercise his individual will, and is not bound to await the ascertainment of the group will, which may not be in accord with his individual will. But he can reach the mortgage security only through the operation of an effective will of the group.

If, on the other hand, he has a certificate of the trustee, which gives him a participation in the interest and principal on the corporate $5,000,000 bond, when, as, and if received by the trustee, he cannot proceed directly against the corporation on his interest in the debt. He does not hold any promise of the corporation. On his debt as well as on his security he must await and abide by the group will.

It may be part of the agreed transaction, however, that the corporation will endorse to the certificate holder its guarantee of payment of the amount which should be paid to the trustee and distributed to the certificate holder. In that case the owner of the certificate does hold the promise of the corporation on which he can sue.

Practically, the difference between the two transactions is not substantial. Action on the debt without resort to the security would seldom be a satisfactory remedy. Besides, the owner of a $1000 bond, or even of five or ten or more such bonds, would seldom want to go alone to the labor and expense of an action at law, when action by the group presumably will be taken that will reach the security.

We shall see this device of the participation certificate utilized in the financing of railroad equipment. There it is based, to be sure, not on a mortgage, but on a closely corresponding situation in which a trustee holds legal title to the security for a loan. It has also been used extensively with mortgage security in group loans for large real estate transactions in the construction of office buildings and apartment houses.

Let us consider now more in detail differences between the individual and the corporate mortgage. Obviously questions of dower do not enter. However much discussion of law may refer to a corporation as an artificial person, it is a person which has no wife. Under the concept of the corporation, title to the corporate assets is not in the stockholders, but is a kind of disembodied spirit; or rather, it inhabits the incorporeal body of the corporate person.

The stockholder has no ownership, legal or equitable, of the things, tangible or intangible, with which the corporation carries on business. So the wife of the stockholder has no dower. Failure to mention dower in connection with the individual mortgage would have left a substantially false picture, but we do not have to consider it further in connection with corporation finance.

CORPORATE AUTHORITY TO BORROW

Since borrowing is one of the means customarily used in carrying on a business enterprise, presumably an authority for a corporation to borrow could be implied from the fact that it chartered to engage in business; and even that the directors could borrow without special authority from the stockholders. The corporation statutes, however, expressly confer on business corporations the power to borrow for the purposes of the business. The authority is also again set forth among the powers in the charter of a corporation. However strongly the authority may be implied from the purpose of the corporation, a lawyer likes to find it not only in the general statute but also in the particular charter.

CORPORATE AUTHORITY TO MORTGAGE

Mortgaging the corporate assets as security for money borrowed is another matter. These assets are the instruments with which the corporate enterprise is carried on. The directors are agents of the stockholders to conduct the business, and may not, without express authority from the stockholders, properly put the enterprise in a situation in which they will not have the tools to carry on with. So, without such express authority, the directors may not sell all, or substantially all, the corporate assets. And generally the corporation statutes require more than a majority vote to confer this authority — commonly a two-thirds vote of all the outstanding stock (i.e., not just of the stock represented at the corporate meeting).

A mortgage, to be sure, does not take away from the corporation the means for conducting its enterprise: the corporation remains in possession of its assets and uses them in its affairs. But it may lose them through foreclosure. So the directors may not mortgage substantially all the assets of a corporation without express authority from the stockholders — and this generally by

the same vote that would be required for a sale of all the assets. The corporate charter, as well as the general corporation statute, regularly includes the power to mortgage, but it may be exercised only within the voting limitation prescribed by the statute. The charter, however, may require more than the statute.

Since unsatisfied creditors on obtaining a judgment might, by levy of execution, force the sale of substantially all the corporate assets, obviously a debt unsecured by mortgage might result in the loss of the instrumentalities for carrying on the corporate enterprise. Yet a stockholders' vote to authorize such indebtedness is not generally required. This distinction is not completely illogical. In the course of reasonably sound business, creditors secured by a mortgage are more likely than creditors without such security to advance sums which jeopardize the continued ownership of the stockholders.

So, in the procedure to authorize a corporate mortgage, the directors call a stockholders meeting on notice of the purpose. The directors may authorize the mortgage subject to the approval of the stockholders, or the stockholders may adopt a resolution and the directors subsequently adopt their own resolution. The resolution of the stockholders may in general form state the amount of the debt authorized to be secured by the mortgage, and that it may be on such terms as to interest rates, etc., as the directors decide; or the resolution may be more specific in various respects.

Resolution or resolutions of the directors will be specific. They will have before them, and by their resolution adopt, a sample of the bond prepared by the engraving company from draft of counsel, and the printed form of mortgage prepared by counsel. Generally, counsel for the bankers, who have agreed to purchase the issue, prepare these forms, and submit them to counsel for the corporation and counsel for the trustee, and the three sets of counsel come to an agreement on them. The directors' resolution expressly authorizes the proper officers of the corporation to execute the mortgage and the bonds secured by it. It is good practice to have essentially the same detailed form of resolution, with form of bond and mortgage attached, adopted by both stockholders and directors. Then stockholders will be unable successfully to contend that the directors have in any way acted outside of the scope of their authority.

In summary, then, the corporate power to mortgage rests on a chain of authority contained in the:

General corporation statute
Corporation charter
Stockholders' resolution
Directors' resolution

FORM OF CORPORATION MORTGAGE

Though the corporation mortgage rests on the foundation of the essential mortgage of real property, as shown in our consideration of that instrument, it is regularly also an instrument of much broader scope, dealing extensively with matters of contract not violating the principles of mortgage. It is likely to be a chattel mortgage as well as a mortgage of real property, and may also be an instrument of pledge. Besides doing these things it declares a trust. Due to its scope, and the magnitude of the property involved, it may run to a document of two hundred printed pages. One of fifty pages containing between its covers nearly twenty thousand words is a small mortgage for a corporation.

Since the instrument is much more than a mortgage, it is usually called simply an indenture, which is broad enough to cover all its provisions. Much of what it contains is dealt with in other chapters. This chapter will present only the framework of the instrument, and those aspects of it which establish it under its full title as a mortgage indenture and deed of trust.

RECITALS

After naming the parties, the mortgagor corporation and the mortgagee trust company, each with its State of incorporation, the instrument presents certain "whereas clauses" containing recitals constituting a preamble. This is not loquacity, however much it may seem so to the layman, but in expressly stating the steps taken to authorize the mortgage and the bonds to be secured by it, they show the foundation of validity, and create an estoppel of the corporation to deny that these things have been done. After the specific recitals, a general whereas clause states broadly the corporate power and that all necessary steps have been taken to authorize the bonds and the mortgage.

A recital will also set out the form of bond and coupon to be issued and the form of trustee's certification. Though these are printed in full, still, as a precaution against accidental and unes-

sential variation, the clause provides that the bonds shall be in "substantially" the form presented.

GRANT

Then follows the grant as in the individual mortgage, with a description of the mortgaged property. A description which clearly identifies the property is sufficient. But parcels of realty owned by an industrial corporation are customarily set forth by metes and bounds as in a deed conveying them to the corporation. These descriptions account for a substantial fraction of the bulk of some corporate mortgages.

CORPORATE MORTGAGE A "BLANKET" MORTGAGE

An individual giving a mortgage generally mortgages a specific parcel, or, at the most, several specific parcels. Though this parcel or these parcels may include all the land he owns, he does not expressly state that he is mortgaging all his property. But generally the substantial value of the corporate mortgage arises out of its being a lien on all the property with which the corporate enterprise is carried on, so that, on foreclosure, the purchaser would be able to continue the business. So the corporate mortgage is generally a "blanket" mortgage, that is, a mortgage on all the tangible assets of the enterprise (and sometimes a pledge of the intangible assets).

CORPORATE MORTGAGE USUALLY A FUTURE ACQUIRED PROPERTY MORTGAGE

For the same reason the corporate instrument generally mortgages all property which the corporation may acquire in the future. We will later consider more fully this provision and its consequences. And we will not enter on a consideration of the law questions involved in making effective a lien on property not owned at the date of delivery of the mortgage, excepting to say that the corporation covenants that it will further expressly mortgage to the trustee such property when it is acquired.

Here we shall remark only that, both in connection with the blanket and the future acquired property characteristics of the mortgage, care should be exercised not to tie up the corporate

business. A manufacturing enterprise, for example, buys raw materials, converts them into its product, and sells them. It finances the business by its cash, accounts and notes receivable, or acceptances. The blanket and future acquired property lien or pledge must not be interpretable so as to prevent the conduct of the business. To avoid such a question the mortgage will contain some provision like this:

"Provided, however, that no merchandise or products completely manufactured and ready for sale, operating supplies, raw materials, partly manufactured products, bills or accounts receivable, credits or choses in action, or stocks, bonds, notes or other securities or evidences of indebtedness, or cash or cash items, now owned or hereafter acquired — the same being hereafter called 'free quick assets' — shall be subjected to the lien hereof."

HABENDUM AND TRUST CLAUSES

In the corporate mortgage the habendum clause of the individual mortgage of course is coupled with the declaration that the mortgagee trustee holds the mortgaged premises "in trust for the equal pro rata benefit and security of all and every holder of the bonds and coupons issued under and secured by this mortgage and deed of trust without preference or priority of any of said bonds over others, by reason of priority of time of issue or negotiation, or any other reason, to the end that irrespective of the date of issue, each and all of said bonds, issued hereunder and outstanding at any time, shall have the same right, lien and privilege under and by virtue of this mortgage and deed of trust, and shall be all equally secured hereby, and further upon and for the trusts, uses and purposes and upon the terms and conditions herein set forth." Here we have an essential of the group loan.

PROVISIONS FOR THE EXECUTION, AUTHENTICATION AND ISSUANCE OF BONDS — CLOSED, OPEN, OR OPEN END MORTGAGES

The mortgage secures a debt. The instrument states the amount of the debt to be secured, i.e., the authorized issue of bonds. This may be a definite amount, as $10,000,000. It may be such an amount as may be issued under the conditions expressly set forth, as that, say, $5,000,000 may be issued forthwith, and further bonds

from time to time on the acquisition of further assets of, say, a value of twice the amount of further bonds issued, or whatever the conditions of issuance may be.

Terminology used to describe such a mortgage is not of universal acceptance. When all the authorized bonds have been issued the mortgage is "closed." That word raises no question. But there are two other possibilities. The authorized amount may be $10,-000,000, of which $5,000,000 are issued. Obviously the mortgage is not closed, but will be when $5,000,000 more are issued.

If, however, there is no limitation of express numbers to the amount of issuance, the mortgage will never become closed. This is sometimes called an open-end mortgage in distinction from the open mortgage which will become closed on the issuance of the authorized specific amount. In actual use the terms are confused, and no single word is adequate. "Unlimited," which is sometimes used for mortgages securing a debt not specified by an express number of dollars, is not accurate, because regularly there are conditions of issuance which are limiting. Anyone dealing with corporate funded debt should be sure that he understands the particular situation.

In this section of the mortgage comes the provision for execution of the bonds by the authorized officers and their authentication by the trustee.

INTERIM CERTIFICATES AND TEMPORARY BONDS

It often happens that the parties to the mortgage transaction desire delivery and payment sooner than the work of preparing engraved bonds can be done. To cover this possible exigency the mortgage authorizes the issuance of "interim certificates" or "temporary bonds" pending the preparation of the definitive bonds. An interim certificate simply calls for the delivery of the bond in exchange: a temporary bond is in the full form of the bonds provided for by the mortgage, but printed or lithographed or otherwise produced in some way more rapid than the engraving required for listing on the New York Stock Exchange.

MUTILATED, LOST, AND DESTROYED BONDS

Here also come the provisions for replacing mutilated, lost, or destroyed bonds on the surrender of the mutilated instrument or

the giving of proper security to protect the corporation in issuing a new bond to replace one declared to be lost or destroyed.

PROVISIONS FOR REDEMPTION

If the corporation stipulates for the right to redeem all or any part of the bonds before maturity, or agrees or reserves the right to call any part of the issue for a sinking fund or otherwise, the mortgage must set forth all the terms of the redemption and the procedure by which it is to be carried out.

COVENANTS OF THE CORPORATION

All the covenants of the mortgagor in an individual mortgage appear in the corporation mortgage, usually expanded with detail. Covenants to pay principal and interest, to pay taxes, not to permit any prior liens to arise, to give additional instruments to perfect the security (covenant for further assurance), are among the provisions of this section of the mortgage. Usually the covenant for insurance is elaborate, providing in full for policies running to the trustee and for the procedure to keep the mortgage security unimpaired in the event of loss. The corporation covenants to maintain the mortgaged premises, and may covenant to furnish the trustee with information about corporate affairs, as an annual income account and balance sheet.

SINKING FUND

If there is to be a sinking fund the contract for it is fully set forth. Since sinking funds are discussed elsewhere in this work, here we merely note the fact that provision for them in the case of creditor securities is part of the indenture under the terms of which the securities are issued.

RELEASE OF MORTGAGED PREMISES

Since it is likely to happen that some of the mortgaged assets may become of no use in the further conduct of the corporate enterprise, ordinarily provision is made for the release of such assets from the mortgage, so that the corporation may dispose of them for something of value to the business. The trustee receives the

proceeds and pays them out on the acquisition of other assets, as in the case of the proceeds of insurance. But it would be inconvenient if a formal release from the trustee were required to permit an old wheelbarrow or other machine or tool to be sold, and the mortgage may expressly permit their disposition without application to the trustee.

DISCHARGE OF THE MORTGAGE

So far, the provisions indicated assume the orderly operation of the mortgage and the performance of the covenants. Continuing on the assumption that the principal as well as the interest of the debt will be paid, the discharge of the mortgage is provided for. A problem arises here. Outstanding bonds, which may be widely scattered, evidence the debt and state that they are secured by the mortgage. Provision must be made to handle the situation of the group creditor.

If there are 10,000 bonds outstanding, it is highly improbable that all will be promptly presented for payment on the due day. Some holders may be abroad without having made provision for presenting their bonds; some holders may be dead, and legal representatives authorized to act not yet appointed; some are dilatory without special excuse. Yet the fact that any bondholder may claim that the premises are subject to a mortgage, to secure his part of the debt, makes it highly important that the mortgage be promptly and unquestionably discharged. Funds to make payment of the existing bonds may be arranged for through a new issue to be secured by a mortgage of the same rank as the existing mortgage, and will not be paid over unless simultaneously a discharge of the existing mortgage is given.

So the mortgage authorizes the trustee to give a discharge of the mortgage on receiving monies sufficient to pay all the outstanding bonds. Further to cut off claims against the corporation by dilatory bondholders, the mortgage stipulates that on the deposit of such funds the bondholder must look solely to the fund, not to the corporation, for payment. It might be that the bank or trust company would fail after such deposit by the corporation, and the fund be lost or depleted. There is no reason why the corporation should have to pay further to satisfy the dilatory bondholder. The corporation has done what it should do. It was ready and willing to pay and tendered payment on the due day at the

proper place, and has done all that it reasonably should be required to do to keep the tender good. All this is the same problem we have seen in connection with the redemption of stock. The matter of the discharge of the mortgage makes the matter more acute.

It is the practice for the trustee formally to burn up the bonds surrendered on payment, and to furnish the corporation with an "incineration certificate" in evidence of such destruction.

EVENTS OF DEFAULT AND CONSEQUENCES

A further section of the mortgage goes on to provide what shall or may happen if the corporation does not fulfil its covenants. Such a failure of the corporation as of an individual is an "event of default." The mortgage allows a period of grace, within which the corporation may make good; but after that period the trustee may act.

Failure to pay interest or principal when due is of course an event of default. If the mortgage provides for a sinking fund, non-payment of an instalment would be made an event of default. Continuances of such failures for the specified number of days are absolute defaults. But failure to perform other covenants is not made a default unless the trustee gives notice requiring fulfilment, and the failure to perform continues the specified number of days after such notice.

On the happenings of an event of default, the trustee may give notice to the corporation declaring an acceleration of maturity of principal; and if a certain percentage of the bondholders, say, twenty-five per cent, make a demand, the trustee must give such notice. This declaration gives rise to the right of foreclosure for the entire debt, and other remedies set forth in the mortgage.

Customarily the mortgage provides that the bondholders shall not take action independently of the trustee except on its failure to proceed; and not then unless a certain percentage of the bondholders, say, twenty per cent, have requested the trustee to act. But foreclosing or exercising other remedies requires the expenditure of money, and may give rise to liabilities, if done in such a way as to violate rights. So the trustee stipulates in the mortgage that it shall not be obliged to act on request unless the bondholders furnish it with security for expenses and possible liability.

The indenture provides for the resignation of the trustee; and for its removal by the specified percentage, say, two-thirds, of the

bondholders, and for the appointment of a successor trustee. In these days of bank mergers it is expedient to provide that the successor institution shall also be the successor in the trust.

SUCCESSOR CORPORATION

One problem may be foreseen and provided for by the indenture. Assume that a corporation sold an issue of fifty-year bonds, and ten years after the sale had an opportunity, which it wished to take advantage of, to sell its assets for cash to another corporation, which would assume payment of the bonds. In spite of the assumption, the issuing corporation as original obligor would, on principle, remain liable, and should not be able properly to make a cash distribution that would impair its capital stock.

Must these bonds, then, be redeemed, if there is a redemption option to enable the vendor corporation to dissolve and liquidate; or must the vendor corporation continue its corporate existence for forty years awaiting determination as to whether or not the assuming corporation will fulfil its liability and so free the issuer? If the issuing corporation cannot dissolve and liquidate on receiving the cash, the advantage of sale will be greatly impaired. The indenture may contract for release from liability on a transfer of assets to another corporation which assumes the bonds. Presumably the problem does not arise on a merger. The successor corporation then continues the issuing corporation, and there would be no distribution which would impair capital stock.

EXECUTION

Execution of the indenture is of course in the usual corporate form, that the mortgagor corporation and the trustee-mortgagee have caused it to be signed by the indicated officers, and the corporate seals affixed and attested by the secretaries.

A layman reader, looking at some mortgages, may wonder why more than one notarial attestation of acknowledgment appears. It may be that the mortgagor corporation has property in more than one State, and the mortgage includes all this property. In that case the mortgage for the protection of the bondholders against purchasers for value without notice will have to be recorded in more than one State. Each State has its own requirements of form of acknowledgment, and it must appear in such form as will satisfy every jurisdiction in which it is to be recorded.

CHAPTER XIX

Maturity of the Corporate Debt—Amortization

Corporations, like individuals, may borrow from Peter to pay Paul. Under some circumstances the process can be justified. A man who borrows $5000 for three years, with the security of a mortgage on a house and lot, does not really expect to free himself from debt at the end of the term. He anticipates that he will be able to induce his creditor to renew or extend the loan for another period; or, if the lender will not, the borrower expects to be able to procure the money from someone else on the same security.

Though the mortgagee knows that the loan will have to be either renewed or refinanced, nevertheless he makes the loan believing the security will continue sufficient for the length of time agreed on. If at the end of that time he thinks the security still good, he may extend the loan at the full amount for another term of three years; or, if he considers the security no longer adequate for $5000, and the borrower can and will pay off $1000, the lender may, on receiving this part payment, extend the loan for $4000.

RISKS OF THE LENDER

In such a transaction the lender has four primary risk elements:

(1) Even with the best of repairs the structure will suffer depreciation.

(2) A decline in the price level may reduce the replacement cost of the house, which will have to compete in rental value with buildings constructed at the lower price level.

Likewise a decline in the price level tends to reduce the income-producing value of the property. Rents go down in the course of deflation as well as commodity prices. The money wage of capital and the rent of land fall with the money wage of labor.

Reduced income capitalizes into a lower price for the things which are capital, and for land.

(3) Changing desires for kinds of housing may reduce the demand for the type of structure mortgaged.

(4) Shifting populations may lower location values.

With the ordinary short term house and lot mortgage, the creditor trusts that these changes will not, during the period, be so great as to destroy the owner's equity protecting the loan. A lender would not make a commitment on such security for a long term without provision for periodical repayment of some part of the principal. Since an investor in creditor securities swaps possibility of profit for reduction of risk, he endeavors to keep an owner's equity between himself and loss. Maintenance or increase of this interest of the owner, through periodical reduction of the debt, we call amortization.

ASSETS AND INCOME

All these hazards of asset value are inherent in corporate enterprise. Asset value and income-producing value correlate. We are familiar with the phenomenon of the almost negligible scrap value of the assets of a business. But they have come to have no value, except as scrap, because in their assembled form they cannot be made of use in the production of income.

Since, where they are, they cannot produce income, their value would drop to zero. But at the cost of demolition of the assembled form, and removal of the parts, someone may be able to use them, in reconstructed form, to produce income elsewhere. However, it is no part of the purpose of this work to develop a theory of investment. We are merely considering practice in connection with funded debt, as related to the risks of relatively long term commitments.

DEPRECIATION A PREDICTABLE RISK

Hazards of the price level, of changing desires, and of shifting population necessarily exist in all enterprise. One danger does not unavoidably appear in all, and presents itself in varying degrees in others; and that is the risk of depreciation. In practice, much of the treatment of debt maturity has concerned itself with this risk, the one hazard predictable with some degree of certainty.

DEPRECIATION AVOIDABLE IN SOME TYPES OF ENTERPRISE

Depreciation, or the wear of weather and use, gradually destroys an asset. An owner of one dwelling house cannot escape loss of value through this course. Owners of a line of railroad can, essentially. For the road itself, the processes of repair and replacements can keep its condition without deterioration.

Replacements can keep the aggregate equipment values unimpaired. Stations necessarily depreciate. Even here, with a number of stations on the line, an essential process of replacement can go on. Values of a new structure may offset depreciation in the old buildings. In this last sense, replacement may offset depreciation in the case of a large industrial enterprise, with many buildings filled with machinery, and, it may be, with a number of plants in various locations.

WHEN MAINTENANCE AND REPLACEMENTS CAN PREVENT DEPRECIATION INVESTORS OFTEN LEND ON THE BORROWER'S EXPECTATION OF REFUNDING

This fact, that maintenance and renewals can offset depreciation, affords the basis for the reliance of some borrowers on refunding to meet the maturity of the debt; and for some lenders in making their commitments without any provision for amortization. Regularly railroads do not amortize their debts, except those incurred on the security of specific equipment.

Indeed, corporate funded debt has tended to deviate widely from the idea of ultimate debt liquidation. Maturity dates often appear so far off that the debt might as well be perpetual. A promise to pay a hundred years from the date of borrowing contains no real element of limitation of creditor risk through maturity. British practice of debentures, perpetual except as default causes principal to be repayable, states the situation more frankly. Under the conditions of such long term debt, investors rely on the creation of a market, which enables them to shift the risk, when in their opinion the change seems desirable. With unamortized commitments for from fifty to one hundred years, we have clearly presented the idea of permanent creditor capital used by enterprisers who have no expectation of paying off out of earnings.

SHORT TERM CREDITOR FINANCING OVER PERIODS OF HIGH INTEREST RATES

If the debt chances to fall due at a time favorable for refunding, when investment money is willing to find employment at low rates for long commitments, the corporate borrower is fortunate. It takes advantage of the opportunity to refund with another long term debt. On the other hand, when the time seems unfavorable, with capital in demand, and commanding high rates, the corporation endeavors to tide over to a more propitious moment with relatively short term loans — for one, two, three, or five years. Lenders and borrowers play a constant game of surmise.

REFUNDING BONDS

In the chapter beginning our discussion of creditor securities, we mentioned the provision of refunding bonds to meet the maturity of underlying mortgage debt. To complete the immediate presentation of debt maturity, we repeat the idea here. The situation appears most frequently in railroad financing, as a consequence of consolidation of connecting railroad enterprises into through lines under one corporate ownership.

As the consolidating corporation took over the separate properties, it was likely to finance the acquisitions in part by placing a new mortgage on the combined properties, subject to the existing mortgages on them. In stating the amount of debt to be secured by the new junior mortgage, the corporation would make the authorized issue large enough, not only to cover the requirements of immediate financing, but also to provide bonds for sale to refund the underlying divisional mortgage bonds, and expressly reserved for that purpose by the terms of the indenture.

SINKING FUNDS

So far, we have considered refunding as a means to meet the maturity of a debt. As we said at the beginning, the corporation borrows from Peter to pay Paul. Depreciation, or other credit conditions of an enterprise, may cause the lender to insist on an amortization of the debt. That is, the investment bankers with whom the corporate managers negotiate to provide the funds may require such provision as a condition of making the loan.

Maybe, aside from the matter of bargaining, the corporate management takes a conservative viewpoint, and desires to strengthen the position of the owners, reduce their risks, by allocating some part of earnings to the reduction of creditor capital. It is to be hoped that such an attitude on the part of management will become more general, and, indeed, that we will have a much larger number of enterprises financed entirely without funded debt.

TYPES OF SINKING FUND

A corporation might set up a general investment fund, buying for it whatever securities it deemed suitable, with the expectation of liquidating for cash to meet the maturity of its own bond issue. Such a course presents several difficulties. If the corporation creates its debt on a 5.20 per cent basis, it will be taking a loss by making investments for the sinking fund at any lower rate. Purchases at a higher rate involve the assumption of greater risks. Then, there is the problem of liquidation. As the maturity of an issue approaches, the security market may be at a low point, and liquidation of the fund fail to provide the necessary cash.

Only one absolutely riskless investment exists in the world. When a man invests in his own debt, he makes a commitment without risk. The assets he acquired with the borrowed funds may lose a large part, or all, of their value; the liability continues absolute, without any abatement — unless, perchance, the State may cease to enforce contractual promises. So a corporation which sets up a sinking fund by the purchase of its own bonds suffers no loss in a rate of sinking fund interest lower than its own rate, does not confront the problem of liquidation with its possibility of loss, and has an absolutely riskless fund.

ACQUISITION OF BONDS

Sections of a corporation mortgage may provide that the bonds may be redeemed or called for purchase by the trustee for the sinking fund. Sometimes the mortgage does not provide for redemption as a whole, but only for call for the sinking fund. This form of call clause reduces the risk of the investor that the bonds will be taken from him at the call price.

Bonds callable at 105 may come to have credit values that would put the market price higher than that point, if it were not

for the possibility of call at that price. Indeed, when that situation does happen a probability arises, if a right of redemption as a whole has been reserved, that the corporation will take advantage of it by redeeming the bonds, and putting out a new issue at a lower interest cost. This constitutes a refunding before maturity. If the bonds are not callable at all, the market will reflect their credit values; if they are callable only for the sinking fund, the investor may be left in possession of an excellent security for a long time.

Corporations may desire to reduce their indebtedness before maturity. The action of the United States Steel Corporation in redeeming its sinking fund five per cent issue, at a time when the redemption meant a tax disadvantage, presents an example of business soundness that subsequent events have shown was most sagacious. To make either debt reduction or refunding before maturity possible, bonds are made callable as a whole or in any part.

As in the case of stock, we mark the distinction between purchase and redemption. We shall see that bonds may be called and purchased by the trustee for the sinking fund and kept alive. Or the corporation may call and redeem bonds. Though the Street does not always, in its language, distinguish between redemption and call for purchase, it interestingly tends to speak, correctly, of "called bonds," a phrase which applies equally to a purchase and a redemption situation.

REDEMPTION TO INCREASE MORTGAGE DEBT

It may seem desirable to increase rather than reduce the amount of creditor capital. The situation may be such, however, that this cannot be done, or cannot be done advantageously, except by clearing off an existing lien, so that a new mortgage may be given without the old mortgage prior to it.

Unless the right to call the existing bonds were reserved, this would not be practicable. In any attempt to purchase the bonds in the open market the corporation would be bidding the price up on itself. Even if it undertook this probably prohibitive sacrifice, it would not in fact be able to get every bond.

And as long as a single bond is outstanding with its rights not cut off by call and redemption, it is entitled to the security of the mortgage. On a call, provision is made for deposit of cash

bonds which should have been presented for payment and notify back to the bank which sent them in for collection. But the bank would also have to note serial numbers to know what depositor had turned over the particular coupons.

Ownership tax certificates attached to coupons for collection now do give the corporation notice of the present, or very recent, owner. To make this information available for notice by mail or called bonds, the corporation would have to note the bond serial numbers on all certificates. Mention of such details may make tedious reading. They are introduced from time to time simply to indicate that group functioning constantly presents problems.

BONDS KEPT ALIVE IN THE SINKING FUND

Sinking fund agreements may provide that called bonds shall be redeemed, i.e., canceled, as in the case of redeemed preferred stock. Other covenants, drawn more astutely in the interests of the bondholder, require that bonds drawn for the sinking fund shall continue, in the ownership of the trustee, to be a debt of the corporation, drawing interest. Interest paid increases the cash for the purchase of sinking fund bonds.

SERVICING OF THE DEBT

In this way the corporation pays a periodical constant cash amount, as a sinking fund instalment of principal; and the amount of interest obligation remains constant, namely, the sum of interest payable on the entire issue. So we have an equal annual instalment of principal and interest. The burden of the debt on the corporation remains constant. Terminology of public finance calls the combination of interest and sinking fund instalments the "service of the debt." Language used of private corporation financing has not yet adopted the phrase.

EXAMPLE OF SINKING FUND WITH BONDS KEPT ALIVE

Below appears the computation of a (substantially) equal annual instalment of principal and interest sinking fund for an issue of $20,000,000 of six per cent first mortgage bonds running for fourteen and one-half years, callable (for the sake of simplicity) at their face amount. With a more careful application of the

sum-of-annuity formula, the sinking fund instalment could be worked out with a closer approximation of accuracy. The tabulation, however, will serve sufficiently to illustrate the principle. Since the assumed $1000 denomination of the bonds makes that the smallest amount that can be called, an application of the formula in practice does not work out with exactness.

	Year	Sinking Fund Instalment	Interest Accrued on Bonds in Fund	Total Amount to Invest	Bonds Purchased	Cash Balance	Bonds in Fund
Sept. 1	1935	$924,000		$ 924,000	$ 924,000		$ 924,000
	1936		$ 55,440	979,440	979,000	$440	1,903,000
	1937		114,180	1,038,620	1,038,000	620	2,941,000
	1938		176,460	1,101,080	1,101,000	80	4,042,000
	1939		242,520	1,166,600	1,166,000	600	5,208,000
	1940		312,480	1,237,080	1,237,000	80	6,445,000
	1941		386,700	1,310,780	1,310,000	780	7,755,000
	1942		465,300	1,390,080	1,390,000	80	9,145,000
	1943		548,700	1,472,780	1,472,000	780	10,617,000
	1944		637,020	1,561,800	1,561,000	800	12,178,000
	1945		730,680	1,655,480	1,655,000	480	13,833,000
	1946		829,980	1,754,460	1,754,000	460	15,587,000
	1947		935,220	1,859,680	1,859,000	680	17,446,000
	1948		1,046,760	1,971,440	1,971,000	440	19,417,000
March	1949	490	582,510	583,000	583,000		20,000,000

The annual burden of the debt is $1,200,000 of interest and $924,000 of amortization, or a total of $2,124,000 for fourteen years, with a balance of $583,000 for the last half year.

REASON FOR KEEPING THE BONDS ALIVE

Keeping the bonds alive clearly illustrates the principle of the burden of the debt. Nevertheless, the practice is not at all necessary for the operation of the sinking fund. If the amounts of sinking fund interest were added to the principal instalment, and the called bonds were redeemed, the process would accomplish the same result in amortizing the debt.

It should be noted that the bonds are bought and owned by the trustee, and not by the corporation. Ownership by the trustee does not constitute an acquisition by the corporation. The corporation has supplied the funds, to be sure, but under agreement for their application to the purchase of bonds for the benefit of the bondholders, the beneficiaries of the trust. The bonds are collateral security as much as if they were bonds of

other corporations bought for sinking fund investment. They remain part of the debt which the mortgage secures.

What good does that do the holders of the outstanding bonds? They have a right to have the entire value of the mortgaged assets applied towards the satisfaction of their claim anyway. That is true. But the larger their claims, the greater their deficiency judgment on foreclosure. And on a deficiency judgment there may be unmortgaged assets for the bondholders to claim against on a parity with unsecured creditors.

This is not inequitable. If the sinking fund had been applied to the purchase of investments, they would have increased the security, and left the total claim outstanding. When we come to consider the problems of corporate reorganizations, we shall see something of the operation of a deficiency judgment on foreclosure of a corporation mortgage.

BREACH OF AMORTIZATION COVENANT AS AN EVENT OF DEFAULT

Under the terms of the mortgage, failure to make the sinking fund payments constitutes an event of default, with the same consequences as failure to pay principal or interest. On the default, the contingent right of the mortgage group creditors, to have the mortgaged assets applied towards the satisfaction of their claim, becomes absolute. They can now take the property away from the stockholders.

Rigid sinking fund provisions may be a menace to corporate solvency. Bankers may not be serving bondholders best by insisting on them. Naturally, stockholders do not want to lose their property. At the moment, however, we are looking at the situation from the viewpoint of those who supply creditor capital. They may well be far better off not to have absolute requirements of a sinking fund result in foreclosure.

At the very least the mortgage should provide that the trustee need not act on this event of default on the demand of as small a percentage of bondholders as may require action for default of interest or principal. And a provision that a two-thirds majority, or even a bare majority, of bondholders may waive an amortization default might be a safeguard.

Possibly a sinking fund might require an absolute obligation to make payments up to actual depreciation, with some margin

of safety added; and make further appropriations depend on earnings. If, up to a certain point, the corporation should apply all earnings to the debt, bondholders might consider themselves in a sufficiently good position.

Stockholders may not want to deprive themselves entirely of dividends. So sometimes sinking funds are set up for an application of a percentage of earnings to amortization. Definition of earnings presents a difficulty likely to lead to disputes. A trustee will not accept much responsibility in this connection. It would insist that it may rely on the statements of the officers of the corporation.

WASTING ASSET SINKING FUND

Amortization of the debt in any wasting asset situation becomes absolutely necessary for protection of the creditor. The ratio of security to debt should not be impaired. If the property is a coal mine, for example, there would be a definite allocation to sinking fund of so much a ton of coal mined and sold.

SINKING FUND MAINTENANCE OF MARKET

Bankers and investors, in requiring sinking funds such as we have discussed, have in mind their collateral effect in giving support to the market. Purchases of bonds for the sinking fund take up offerings and help maintain price. Such market support adds an element of value to the bonds.

SERIAL MATURITY

Prudence may demand, in some situations, an even stronger assurance of protection against impairment of security than even a mandatory sinking fund affords. So we see resort to another device for amortization — that of serial maturity. The promise to pay part of the debt directly to the creditor is not, as far as the law goes, any stronger than a promise to pay a like part indirectly through the operation of a sinking fund. But creditors who have not received payment of principal, in accordance with the promise they hold, utter a far louder cry of pain than that which goes up on notice of a default in the sinking fund. Serial maturities put more pressure on the corporate obligor than amortization instalments payable to the trustee.

Railroad equipment financing presents an illustration. Specific cars and locomotives secure the loan. Their life is limited. Renewals do not replace values lost by depreciation. In five years it will have taken a substantial toll. Amortization becomes vital to security. So equipment loans regularly mature serially. And since depreciation does not adjust itself to the financial convenience of the enterprise, the lenders demand that it pay off the debt in equal instalments of principal, not equal instalments of principal and interest.

Serial maturity destroys the uniformity of an issue and creates a market disadvantage. In a loan of $15,000,000 with a sinking fund, every one of the 15,000 bonds for $1000 each is just like every other. All fall due at the same time. Calls for the sinking fund, to be sure, may hit some earlier than others. But all have the same chance of being called. Quotation of a single figure gives the market price for all.

A loan of $15,000,000 maturing serially, $1,000,000 a year for fifteen years, presents a very different picture. Sometimes market conditions cause short term securities to sell more advantageously than long term; sometimes the reverse. Even though all maturities enjoy the same credit, they sell at the same price only when that credit exactly coincides with the coupon rate. At a discount or premium the price quotation differs for each maturity. A basis rate affords the only single quotation available for all maturities.

We have, in effect, fifteen issues of $1,000,000 each, instead of one issue for $15,000,000. And dealings in a $15,000,000 issue are likely to create a much better market than dealings in a $1,000,000 issue. Still, the importance of the pressure of serial maturity may outweigh the market disadvantage of the form.

Fourth Section

Capitalization: Expansion

CHAPTER XX

Capitalization

Elsewhere we consider the problem of permanent and of temporary capital in an enterprise. Briefly, of its total requirements, it does not use some of its capital throughout the year. Within the limitations which business practice imposes, the enterprise can properly finance by current credits the capital we will call temporary. Some part of the capital, though represented by current assets, remains permanently in the business. This, which we call working capital, is just as permanently in the business as land, buildings, and machinery; and it needs just as permanent financing. The specific items of wealth change; the aggregate of their value does not. We are not concerned with the current credits, but only with the permanent financing.

QUESTION OF RELATIVE AMOUNTS OF OWNERSHIP CAPITAL AND OF CREDITOR CAPITAL

Of this permanent financing we have so far considered the distinction between creditor capital and contributed ownership or stockholder capital. We have not considered the relative amounts of each which an enterprise may properly have, and will take that as our next subject for discussion. When extended to types of creditor securities and classes of stock, our subject becomes the plan capitalization.

Can we find any principles determinative of the amounts which may lie on each side of the great divisional line between creditor and stockholder financing? If a corporation fails to fulfil its obligations to creditors, the stockholders lose their enterprise. The creditors liquidate or reorganize it; and if the stockholders have any part in the continuing concern, they have to make a new contribution of capital to acquire it. (This last remark is subject to what the courts may do in working out Section 77B reorganizations, which will be discussed later.)

TRADING ON THE EQUITY

Adopting terminology from the equity of redemption of a mortgage, business men extend the idea of "an equity" to any interest in property, and especially speak of an owner's equity. To represent the situation of the owner of a business who provides part of the capital he uses by borrowing, we are beginning to use the phrase of "trading on the equity."

HOPE THAT PROFITS WILL BE GREATER THAN THE RATE OF INTEREST

Why does the owner of a business go into debt to provide capital? He does so because he hopes he will be able to make the capital earn more than he has to pay for it. Obviously he accepts the risk that on his failure to make the business earn as much as he has to pay for the borrowed capital, his creditors will eventually take the assets of his business away from him. He must keep on paying them the wage of their capital until he exhausts his own capital in the process.

EXAMPLES

Let us assume an enterprise with capital of the value of $1,000,000 represented by capital stock in the same amount. At a time when the business can earn ten per cent on the capital it employs, it expands by borrowing $1,000,000 on a long term bond issue carrying interest at the rate of six per cent.

Situation before expansion, when earning ten per cent on capital employed:

Assets	
Plant, etc.	$1,000,000
Liabilities	
Capital stock	$1,000,000
Income	
Available for capital	100,000
Per cent available for stockholders	10%

Situation after expansion by issuing $1,000,000 of six per cent bonds, when still earning ten per cent on capital employed:

Assets	
Plant, etc.	$2,000,000
Liabilities	
Capital stock	1,000,000
Bonds	1,000,000
Income	
Available for capital	200,000
Interest	60,000
Available for stockholders	140,000
Per cent available for stockholders	14%

By borrowing under the conditions stated, the stockholders have increased their rate of earnings from ten per cent to fourteen per cent.

Let us assume further that in a year of great business activity the rate of earnings on capital increases to fifteen per cent. Then we have:

Income	
Earnings on $2,000,000	$300,000
Interest	60,000
Available for stockholders	240,000
Per cent available for stockholders	24%

As long as the general economic situation, and conditions of the particular enterprise, continue on the up trend, with earnings on capital employed increasingly greater than the interest rate on the bonds, expansion by borrowing seems a more than royal road to wealth.

Consider, however, what happens when the trend goes the other way. Let the rate of earnings on capital employed decline to five per cent, and we have:

Income	
Earnings on $2,000,000	$100,000
Interest	60,000
Available for stockholders	40,000
Per cent available for stockholders	4%

If the enterprise had not borrowed, the stockholders would have earnings at the rate of five per cent instead of four per cent.

Accentuate the situation, and have the corporation earn only two per cent on capital employed, and we have:

Income	
Earnings on $2,000,000	$40,000
Interest	60,000
Deficit for stockholders	20,000

Now, so far from benefiting by the borrowing, the stockholders will have to dip into their capital funds to make good the deficit. Unless the situation changes in time, they will have to default in the payment of interest, and the creditors will take the concern away from them. If the stockholders had not borrowed, their ownership would not be threatened until the situation forced them to produce at less than cost without any return on capital. Then, to be sure, even if they should shut down the plant to stop the loss from operations, depreciation and taxes would be eating up their capital. Inability to provide funds for taxes would result in loss of ownership through a tax sale. But they could tighten up the belt and survive much longer, with the increased speculative chance, offered by the greater period, that conditions would change before their economic death.

All this demonstrates the obvious. However, in the affairs of men, the obvious seems often to need elucidating. Creditor financing is the pivot on which the seesaw of the optimist and the pessimist turns. Optimist stockholders, trading on the equity, see their end on the up and up. Pessimist lenders, seeking the protection of the stockholders' equity, envisage at least the possibility of the stockholder end going down, with an equivalent rise in advantage of the creditor end.

PURPOSE OF THE INVESTOR IN THE CREDITOR CONTRACT

Yet the man with capital, even the creditor, can be only the comparative, pejorist, and not the superlative, pessimist. He cannot escape risks. Of necessity his control over wealth is always committed somewhere. Cash in a safe deposit box is not safe from loss in value. A deposit in a bank is only a form of creditor commitment. He must in some degree live on hope. The risks are there, economic and political. After they have broken the borrower they may break the lender. Indeed the political hazard of currency depreciation may break the lender and save the borrower.

Creditor finance seems to perform the social service of giving a man who refrains from present consumption, in order that he may consume in the future, a sounder expectation that he will in the future have the wherewithal to consume. And this greater probability would be created, if it were not for the political

hazard of currency manipulation unjustly enriching owners, and the economic hazard that changes in the price level, apart from currency manipulation, will make the creditor's future consumption much less than his present economic ability to consume if he did not refrain.

It may be questioned, aside from the political hazard, whether the economic risks of any workable creditor contract so far devised are not such as to render man's reach for future safety, through such means, more hazardous than assuming the economic risks of an ownership not jeopardized by debtor promises. There well may be, too, a general social utility in ownership of such character. Indebtedness creates rigidities that may have to be broken down by the reorganization process, and resistance may unduly delay economic readjustment. Besides, reorganization in some degree temporarily disorganizes.

To have more of absolute ownership, as contrasted with equity ownership, for the benefit of the man who, by refraining from present consumption, seeks future safety, he must solve the problem of control and management, so that enterprise will avoid seeking great profit through the assumption of great, but avoidable, risks. During the period of the down trend in business, while we are engaged in damning some of those in control and management, as they deserve to be damned, whose conduct contributed to instability, we should remember some of the many examples of the admirable management of men who worked for stability as sagaciously as men can work.

It is unfortunate that our tax laws have given a special advantage to creditor financing. Federal taxation of corporations, and some State taxation, makes levies on incomes, and takes as the income figure the income available for ownership, which is after deduction of interest. So the corporation financed with creditor securities reduces the amount of its income by the amount of the interest. One might question if the point for computing income for taxation ought not to be at the income available for capital instead of income available for one class of capital. The question is presented with an awareness of complications in practice.

LIMITS OF TRADING ON THE EQUITY

Now that we have seen the general problem of trading on the equity, let us consider if there are any principles which may

serve as a guide to the extent to which it may be reasonably carried by stockholder owners desiring to undertake its risks. This statement of stockholder desire may sound somewhat ironical in view of the usual course of promotion. In capitalizing an enterprise the promoters commonly get the funds in the easiest way possible. Ordinarily, this is by an appeal to the speculative minded for some equity capital, and to those who seek the protection of a creditor contract for the rest. Still, essentially, this means a group of stockholders willing to accept the risks. The social danger lies in their commitment being small, and the creditor believing it greater than it is. The speculative stockholders may be taking a hundred to one shot.

Stockholders preserve their ownership as long as earnings available for capital are sufficient to pay the interest charges. If they do not obtain creditor capital in amounts any larger than they can pay for under the most difficult circumstances, their creditors will not take their property away from them, at least until the maturity of the principal of the debt. To break down the problem for analysis, we will disregard maturity, and consider how far the stockholders may reasonably go as limited only by the amount of the interest charge.

VARIATIONS IN GROSS

Earnings available for interest are not figures which stand independent of other matters. Such earnings are derivative. In the first place, they depend on the amount of gross earnings. A variation in gross tends to cause a variation in net available for capital. So, through the probable variation in gross, we get our approach to the problem of a capitalization including creditor securities.

A complicated series of factors of demand and price, themselves interrelated matters, causes gross to vary. We will not concern ourselves with these causations, but will simply observe the fact that gross does vary. Further, we will observe that the tendency of gross to vary, itself varies with different kinds of business.

COSTS NOT REDUCIBLE PRO RATA WITH DECLINE IN GROSS

Next we have to consider what takes place between gross income and earnings available for interest. We have the costs of

doing business. Some of these costs can be reduced in an approximation to the rate of reduction in gross. But many cannot. Quite apart from the costs of capital, a plant usually operates at lowest cost per unit of output when it runs at capacity. Items of overhead do not fall in the same ratios as the fall in gross. Costs of management may be reduced, but not in proportion. Insurance and property taxes do not fall at all.

RATIO OF COST TO GROSS

We need to introduce the term "operating ratio." It means, as we shall use it in this chapter, the percentage of gross consumed in costs before arriving at income available to compensate capital. That is a loose use of the phrase, and not exactly the sense in which it is ordinarily taken. But it is a convenient term, and with this explanation ought not to mislead the reader. Perhaps we should use the phrase "costs ratio"; but that would still need definition. Under a definition different from the one we are taking, an operating ratio may be used as an index of efficiency, which may be due to skill in management or to efficiency in plant.

As we are using the phrase, it includes such items as property taxes, with which efficiency has nothing to do. Though we are interested in the efficiency of management aspect of production, the extent to which costs can be reduced to keep the unit of production cost from increasing, we are interested in it primarily as a means of arriving at income available for capital. Since such overheads as taxes must come out of income before capital changes, we are including them under the term "operating ratio" to shorten our presentation. Also, it may be remarked that, under the customary use of the phrase "operating ratio," which was developed in the study of railroad earnings, the concept is not applicable to fabrication enterprises, in which the cost of materials enters so much more largely than in a service business. These also are costs which have nothing to do with either efficiency of plant or efficiency of management.

Let us go on to consider these variations in gross, operating, and net available for capital, as they appear in certain representative businesses. At the moment of writing we have hardly begun, if, indeed, we are yet started on, the up swing of an economic cycle. It would be more interesting to take the figures

showing the completion of a cycle. However, they would hardly be any more useful for our purposes than the figures of the incomplete current period.

In treating the same topic in 1912, the figures for the 1907 period were taken. But, besides the special interest in more nearly current figures, the reader might question if conditions had not changed so much that ideas derived from the earlier cycle were no longer applicable. And the war period later might be considered as affected by other than the usual economic conditions. We have taken for our examination now the years 1928 and 1929, as representing the top and the end of the latest up swing of the cycle, and have carried the figures through the year 1933 as indicating sufficiently, for our purposes, the effects of the down swing.

VARIATIONS IN GROSS AND OPERATING OR COST RATIO IN THE STEEL BUSINESS

We will examine first an enterprise in the steel industry, proverbially the Prince and the Pauper among businesses. The concern taken is the United States Steel Corporation:

Year	Gross Revenue	Operating Charges, Taxes, etc.	Net Revenue	Ratio
1928	$1,374,443,433	$1,183,562,726	$190,880,707	86.1
1929	1,493,505,485	1,234,953,734	258,551,751	82.7
1930	1,180,934,971	1,040,904,423	140,030,548	88.1
1931	729,377,467	701,567,560	27,809,907	96.2
1932	357,201,705	377,553,087	def. 20,351,382	105.7
1933	524,968,768	507,499,810	17,468,958	96.7

ENTERPRISES SUBJECT TO OPERATING DEFICITS MUST ACCUMULATE RESERVES FOR ANY INTEREST CHARGES

Here, in the figures of the steel company just given, we see that as the gross declines the costs ratio of 82.7 per cent, in the year of maximum gross, increases to 105.7, in the year of minimum gross. This took place in the course of a decline in gross to twenty-five per cent of its top figure. We have the result of not only no earnings to compensate capital, but a deficit. So

labor not only had the use of capital without payment, but was paid more in 1932 than its product was worth.

Owners of such a business cannot, with reasonable safety, trade on the equity at all, unless, with a prevision of the situation, they accumulate the means of paying interest to an amount probably adequate to carry them through without default.

In the steel business we have a capital goods industry. During a period of economic maladjustment, the community, far from increasing its capital, essentially consumes former capital accumulations through failure to maintain existing assets. We live on depreciation. Of course we are not using the word "capital" in this paragraph in its strict economic sense of wealth used directly for increasing production; but in a loose social sense, in which we count as capital all wealth of a relatively permanent kind accumulated to make life more comfortable, as houses.

Consideration of these figures of the steel company shows the wisdom of its management in paying off a greater part of its debt at a time when financial conditions permitted, even at the cost of losing a tax advantage in so doing.

AN ENTERPRISE IN THE CHEMICAL INDUSTRY

Let us next examine an industrial concern manufacturing specialized commodities in the chemical field. It is Air Reduction Company, Inc., which produces oxygen, nitrogen, etc. To whatever economic conditions its situation is due, it shows a relatively fortunate position. With a decline of nearly fifty per cent in gross, its cost ratio rose from 72.6 to 86.2, but still leaving it with a net available for capital nearly one-third of its maximum net.

Year	Gross Revenue	Operating Charges, Taxes, etc.	Net Revenue	Ratio
1928	$15,652,009	$12,244,692	$3,407,317	78.2
1929	21,801,294	15,828,998	5,972,296	72.6
1930	19,515,133	15,046,458	4,468,675	77.1
1931	15,641,353	12,428,697	3,212,656	79.4
1932	11,730,889	10,115,269	1,615,620	86.2
1933	13,443,833	10,769,179	2,674,654	80.1

RAILROADS

Now we will leave the field of industrial enterprise and take an example from the field of transportation. Figures for the Pennsylvania Railroad show the following:

Year	Gross Revenue	Operating Charges, Taxes, etc.	Net Revenue	Ratio
1928	$650,567,316	$518,017,991	$132,549,325	79.6
1929	682,702,931	533,669,188	149,033,743	78.2
1930	570,465,360	462,844,937	107,620,423	81.1
1931	448,090,279	382,835,668	65,254,611	85.4
1932	331,393,458	270,243,033	61,150,425	81.5
1933	324,715,814	251,227,947	73,487,867	77.3

Here we have one of the great trunk lines. A diversified transportation business such as this does not show the extreme variations in gross which take place in some of the industrials. Social demand for a particular manufactured product may almost cease. But under modern conditions nearly all products enter into transportation. We are not delaying to consider the effect on the railroad business of the rise of a competitive form of transportation in the motor truck. Such a change may take place in any field of enterprise. It had become influential in the railroad business by the year of maximum gross. In any event, it is not substantially relevant, and we may take the railroad business as representative of a diversification of risk in the elements of gross income. We see the ratio of costs rise from 78.2 in the year of maximum gross to 85.4 after gross had declined more than a third. We compare the one-third decline of gross in this railroad business with a decline of seventy-five per cent in the steel business and of fifty per cent in the chemical business.

PROBLEM OF SQUEEZING DOLLARS FOR INTEREST OUT OF MAINTENANCE

Interestingly here, we see further losses in gross with a ratio declining instead of increasing as it ought to do if our theory is true. We are not attempting any analysis for this enterprise, but will content ourselves with some general observations. Confronted with a corresponding situation, one would first suspect and then examine the maintenance allowance.

For a true showing of a business situation maintenance should be substantially a constant. And a like constant should appear in deductions for depreciation reserves in situations in which maintenance does not adequately offset depreciation. But under the pressure exerted by ownership to squeeze out monies for interest, management will skimp maintenance to get dollars to prevent default. To reflect such a situation the accounts ought to show an increase in a depreciation account; an increase which, to say the least, is quite likely not to appear.

Maybe a management has succeeded in reducing a wage scale. Prices of materials may have fallen more than the price received for the commodity produced or the service rendered. Whatever cause may account for the reduction in the ratio to a point below even that of the ratio at the maximum gross, the increase for two years of declining business seems to indicate the operation of the same principle which seems to appear in the preceding illustrations.

HYDRAULIC ELECTRICAL ENTERPRISE

Next, we will look at a very different type of business, that of a hydraulic electrical power company engaged mostly, or at least largely, in wholesaling power. For our illustration we take the Shawinigan Water and Power Company. Here we have a business with a large capital investment which requires a relatively small amount of labor. We see this condition reflected in the costs ratio. That of the Pennsylvania Railroad ranges from 77.3 to 85.4. In the case of the power company it runs between 38.3 and 49.5. Presenting the figures:

Year	Gross Revenue	Operating Charges, Taxes, etc.	Net Revenue	Ratio
1928	$11,562,331	$5,263,807	$6,298,524	45.6
1929	13,475,863	5,510,129	7,965,734	40.9
1930	14,954,075	5,732,597	9,221,478	38.3
1931	13,693,194	5,433,081	8,260,113	39.7
1932	11,953,010	5,440,932	6,512,078	45.6
1933	11,945,864	5,911,735	6,034,129	49.5

With the power company located in Canada, we find 1930 still a year of increased gross. We see the operating ratio fall from 45.6 in 1928 to 38.3 in 1930, through two successive increases in

gross. It is interesting to observe the sharp increase in the ratio in 1933 on an almost insignificant decline in gross. We will not delay to seek the cause in this particular case, or to comment generally on methods of bookkeeping or other means which may result in an indicated retardation of the effects of the principle of our theory.

It is clear that we have a picture of an entirely different kind of business from that of the two industrial enterprises we have looked at, and from such a service business as that of the railroad. Though a wholesaler, the power company sells in considerable part to distributors. With our next enterprise we will discuss some of the reasons why the gross of an electric lighting company does not decline, except under a reduction in rates. To the extent that a power company sells to distributors of current for domestic use, their demand keeps up the revenue of the wholesaler. Yet Shawinigan sells also a substantial part of its power to large industrial consumers. Their demand for power falls with the decline in their output. Very likely the nature of some of the power contracts prevents the effect of the decline in demand from being fully reflected in gross. That is, it may be that some of the contracts call for a minimum payment, whether or not use is made of the power.

A GAS AND ELECTRIC LIGHT COMPANY

Turning to the last of our selections of types of business we will examine the earnings of a company distributing gas and electricity. Doubtless it sells to some extent to industrial concerns, but probably this source of revenue does not supply a great proportion of the whole of gross. The figures are those of the Consolidated Gas, Electric Light, Heat & Power Company of Baltimore.

Year	Gross Revenue	Operating Charges, Taxes, etc.	Net Revenue	Ratio
1928	$26,126,194	$17,341,149	$8,785,045	66.7
1929	28,017,878	18,185,459	9,832,419	64.9
1930	28,582,423	19,318,662	9,263,761	67.06
1931	28,499,247	18,847,089	9,652,158	66.1
1932	27,506,531	18,715,207	8,791,324	68.0
1933	27,465,444	18,948,115	8,517,329	69. –

Our first observation is that gross hardly declines at all. Its minimum is ninety-six per cent of its maximum. To a considerable extent this kind of enterprise sells what is a necessity in an urban area. Use of its product extends to some extent beyond the necessity. However hard the times, American consumers seem to be able to afford a degree of luxury. They do not economize much on habitual expenditures. So public utility concerns of this kind show a remarkable constancy of gross at any given rate level.

Also we note the close inverseness of the cost ratio to gross, falling as gross rises and rising as gross falls. Though the ratio is higher than that of the power company, it is much lower than that of the railroad. The changes in the ratio appear to reflect the principle of our theory. A larger element of labor costs than in the case of the power company adds to the rigidity of total costs.

An analysis of corresponding figures in various types of business for the cycle known by the year 1907 shows the same kind of results as the figures for the incomplete cycle we have examined.[1] If we can count on experience repeating itself, a business of the domestic consumption gas and electric type could safely finance with a large proportion of creditor capital. We have not presented an opinion in any of these cases of what proportion of the total capital might be of the creditor type. As we have noted, such a concern as the steel company cannot safely have any creditor capital, except on condition of accumulating reserves sufficient to carry it over periods of operating deficits.

SINKING FUND REQUIREMENTS MUST BE ADDED TO INTEREST AS CREATING THE CHARGE WHICH MUST COME WITHIN THE LIMITATION

So far we have considered the problems only from the viewpoint of interest charges. The discussion could leave at this point only a debt without maturity. If investors insist on a mandatory sinking fund, the annual charge on its account increases the amount which must be kept within the limitations of earnings. And in creating any maturing debt the fact that principal must be repaid or refunded must be kept in mind. To be

[1] The 1907 figures appear in Hastings Lyon, *Corporation Finance*, Book I, Chap. II, "Trading on the Equity."

sure, with a term fifty years or more away, the lender probably feels that his bread is cast on the waters of fortune.

A little work with a lead pencil in any case will show the probable maximum of creditor capital. Such maximums are dangerous. Squeezing dollars out of maintenance defeats itself in no great period of time. Operating costs of a plant not in the best of repair go up. Increases in operating expense soon offset the dollars not spent for maintenance. And soon after that the plant becomes dangerous to run without patching.

Investment bankers used to have a rule of thumb that the bond issues of an industrial enterprise should not be more than one-third the amount of the permanent assets, and that interest charges should not be more than one-third the earnings available for capital, with earnings computed on an average of five years. A railroad situation was considered sound if interest did not consume more than half to two-thirds of available earnings.

One may hope that we shall go into a period of more conservative financing than that of past practice, a period of less endeavor to make equity profits. The investor will then have his choice between either creditor securities of a high grade, or the possibilities of income arising out of sounder ownership. Whether we have more cautious financing or not, the future of creditor securities, from the viewpoint of the investor, depends on the degree of confidence he may have in the currency. If he must add a serious political hazard to his other risks, the chances are too great to be taken. He had better abandon the creditor field and accept the ownership risks.

CLASSIFICATION OF OWNERSHIP AND CREDITOR SECURITIES IN CAPITALIZATION

Classification of the two broad types of capital, creditor and ownership, may be carried to a variety of issues of both types. The essential division runs between the two. Consideration of the subdivisions lies in the field of investment more than in that of corporation finance. Yet an observation or two may be pertinent.

Let us, disregarding current liabilities, consider two corporations, A and B, capitalized as follows:

A

Assets

Plant, etc.	\$3,000,000

Liabilities

Bonds, 5s	$1,000,000
Stock	2,000,000

Earnings

Available for capital	$150,000

B

Assets

Plant, etc.	$3,000,000

Liabilities

Bonds, First 5s	$1,000,000
Bonds, General 5s	1,000,000
Stock	1,000,000

Earnings

Available for capital	$150,000

Earnings available are three times the amount required for the A 5s and for the B First 5s. Yet if these earnings should decline fifty per cent, B would default on its General 5s, and a reorganization of B would be necessary. Unless the situation grew worse there would be no default on the B First 5s. Still, the financial difficulties of the corporation probably would affect the B First 5s in the market.

Further, consider the following statements:

A

Assets

Plant, etc.	$3,000,000

Liabilities

Bonds, 5s	$2,000,000
Stock	1,000,000

Earnings

Available for capital	$200,000

B

Assets

Plant, etc.	$3,000,000

Liabilities

Bonds, First 5s	$1,000,000
Bonds, General 5s	1,000,000
Stock	1,000,000

Earnings

Available for capital	$200,000

Interest on the A 5s is earned two times the amount required. In the case of B, deducting $50,000 for the First 5s leaves $150,000 available for the General 5s, or three times the amount required. But obviously the B General 5s are not as good a bond as the A 5s. At the very worst the A 5s will take the property. But if earnings should fall below $50,000, the B General 5s would be wiped out, and the B First 5s would take the property.

CHAPTER XXI

Expansion of the Corporate Enterprise

In this connection we mean by "enterprise" a business of whatever ramifications carried on under the control of one stockholder group, whether by one corporation or by the corporation and subsidiary or controlled companies; and by "expansion" we mean additions to the capital, whether creditor, lessor, or stockholder, with which the enterprise is carried on. Such capital increment is generally the crux of any enlargement of the scope of enterprise. Methods of expansion are not mutually exclusive. A single enterprise may employ in its development all those we shall consider.

THE SINGLE CORPORATION EXPANDING THROUGH RETENTION OF PROFITS OR EARNINGS

Simplest of all the methods of expansion is development through the retention of profits or earnings in the business. Most sound individually or partnership owned businesses grow in this way. And it is a sound way for corporate business to grow. A business built up out of its own earnings is not likely to grow faster than the management can master its problems. Management develops in experience and skill as the business develops. Great new risks are not suddenly taken into the enterprise with sudden great additions of capital. In the application of this method to corporate business, however, certain questions arise.

In the corporation, the director management makes the appropriation without reference to the stockholder owners. If a majority of the stockholders are not satisfied with the dividend distribution policy, they can, to be sure, elect other directors. But if the majority stockholders are satisfied to have earnings legally available for dividends withheld from distribution and kept in the enterprise as additional capital, an unwilling minority must abide by the decision.

Strictly, the minority stockholders are not injured by such a result. They knew they were entrusting themselves to a corporate form of enterprise, and that their desires for the distribution of income might not prevail. Yet one may question how far a board of directors (or a majority of stockholders electing them) ought to go in appropriating earnings to capital purposes. By such an appropriation the minority become contributors of additional capital to the enterprise against their wills.

There are possible mitigations. Presumably the retention of earnings in the enterprise increases the value of the stock. If the stock enjoys an active market, presumably the market price reflects the enhanced value. The stockholder can collect his income by selling part of his holdings. But in practice he would arrive at only an approximation of maintaining a distinction between his principal and income. If he does not like the situation he can sell all his holdings and reinvest in the stock of some corporation which has a dividend policy in accord with his ideas.

When the animus back of the retention of earnings is not solely a policy for expansion of the business the matter becomes more open to question. With the heavy Federal, and sometimes State, income taxation, since the World War, many capitalists have in some degree managed their affairs in the hope that in the course of time this taxation would become lower. Corporations have to pay the income tax on their incomes irrespective of the dividend policy. But the stockholder does not have to pay any tax on his share of the corporate earnings which is not actually paid to him.

A conflict of interest between the small and the large capitalist may arise. If the income of the small capitalist does not reach the point at which the surtax begins to apply, he does not have to pay any tax by reason of dividends received. The corporation's payment of the tax on its income relieves the stockholder of the payment of tax on dividends to the amount of the normal tax. Such a small capitalist has no possibility of tax advantage through a corporate retention of income. A relatively large capitalist, however, with an income which reaches the higher surtax rates, may prefer that the corporation retain earnings in the enterprise, with the hope of a reduction in surtaxes, and that then earnings, enhanced by the use of additional capital, may be distributed to him. This hope has now been disappointed for nearly two decades, yet like other hopes it springs eternal.

RETENTION OF EARNINGS BUT PAYMENT OF STOCK DIVIDENDS

Sometimes corporate managements make an endeavor at eating the cake and having it too by the payment of stock dividends. Assume a corporation in this position:

Assets	
Net worth	$11,200,000
Liabilities	
Capital stock	$10,000,000
Profit and loss	1,200,000
	$11,200,000

Instead of paying any cash to stockholders, the directors (having sufficient authorized and unissued stock available) declare a dividend of ten per cent, aggregating $1,000,000, payable, not in cash, but in stock of the corporation, and transfer $200,000 from profit and loss account to surplus. The corporate statement then becomes:

Assets	
Net worth	$11,200,000
Liabilities	
Capital stock	$11,000,000
Surplus	200,000
	$11,200,000

The Supreme Court of the United States has held (*Eisner v. Macomber*, 152 U. S. 189) that on the issuance of stock as a dividend the stockholder has not received any income. The stockholder, who owned a certificate for ten shares, received, in the process just indicated, a certificate for one share additional. The two pieces of paper represent exactly what the one piece of paper represented, a ten-thousandth interest in the enterprise. If the ten shares of stock cost the stockholder $1000, or $100 a share, he now owns eleven shares at his original cost of $1000, or at a cost of $90.90 a share. On a sale now of one of his shares for $100, he will make a taxable profit of approximately $9.10.

Looking for the real crux of the matter, we see that the stockholder's investment in the corporate enterprise, represented by the stock dividend, was not voluntary. His share of the income

was appropriated willy-nilly as capital, just as much as if no dividend of any kind had been declared. The payment of the stock dividend did not place disposable funds in the stockholder's hands. By further action, namely, the sale of the share received as a dividend, he can get disposable funds. But so he could have acquired them by the sale of one of his original ten shares. Decisions of the Treasury Department have gone generally along this line.

In one case, the corporation, by charter provision, made its dividends payable in stock unless the stockholder notified it of an election to take cash. The opinion of the Treasury Office was that the stockholder who did not notify an election to take cash, and, therefore, received stock, would have a non-taxable stock dividend. (G. C. M. 6709 VIII-39-4367 as quoted in Prentice Hall Tax Service, 1929.) The matter seems very close. But after all, the stockholder had to take affirmative action in order to receive disposable funds. The corporation did not of its own initiative place such funds in his possession. One doubts the continuance of the ruling.

By the payment of a stock dividend, the wealthy capitalist, with the heavy surtaxes, does not receive taxable income. His values accumulate in the corporation against the hoped for better day. The small capitalist can, if he wishes, sell his stock dividend and realize disposable funds. He is put to the hazard of the market in doing so. Compared with the possibility of his doing a corresponding thing, through the sale of part of his original holdings, he can, by the stock dividend, keep his investment accounts to correspond accurately with those of the corporation. The situation approximates that of a corporation paying a cash dividend, at the same time offering to stockholders an additional issuance of shares, with the small stockholder not subscribing, but selling his right to subscribe, if it has value. But by this procedure the large capitalist would receive taxable income.

What has just been said about stock dividends needs the addition of the later discussion of the undistributed profits tax in the chapter on the taxation of corporations. The kind of stock dividend which would not be taxable income to the stockholder under the principle of *Eisner v. Macomber* presumably would not amount to a distribution of profits so as to escape the corporation tax on undistributed amounts. The interrelationship of concepts in the constantly shifting tax statutes becomes intricate. We can do no more than take notice of the existence of some of the problems.

EXPANSION THROUGH SALE OF ADDITIONAL CAPITAL SECURITIES

Unless capital used in the enterprise is acquired through the appropriation of earnings of the business itself to use as capital, an expanding corporation must dispose of capital securities. It may do so by sale; or by issuance in exchange for securities of another corporation, in the course of the acquisition of a subsidiary, consolidation, or merger. Contracting to pay rent for leased assets may be regarded as equivalent to the sale of capital securities. Indeed, we may consider the lease, in a sense, a security of a creditor character. Issuance for capital funds may be either of creditor securities or of capital stock.

FORMATION OF SUBSIDIARIES

It may be that a corporation will not acquire directly all the capital assets used in development and expansion, but will extend the scope of its enterprise in part through the formation of subsidiary corporations. Reasons for the formation of subsidiaries are various. One, to obviate the effect of a future acquired property clause in an existing mortgage, we will consider fully in a subsequent chapter.

An enterprise in a construction state may utilize subsidiaries, each undertaking its part of the total construction and segregating its risks within itself. Building a line of railway, sections and branches of which are easily separable for construction purposes, presents an opportunity for such a use of subsidiaries; all of them might be dissolved on the completion of the road, and the total line taken over by the one corporation which was to operate the property.

It may be desirable to divide the totality of an enterprise among corporations in separate States, each of which carries on the business in the jurisdiction as a subsidiary of the parent company controlling the business in its entirety. Such a process might well be a convenience in the rendering of corporate reports. Each subsidiary would make its separate report to the jurisdiction in which it is incorporated and in which it does business. This would avoid questions of correct segregation of assets for the purpose of taxation, if that were necessary under the tax laws of the State.

Sometimes an enterprise finds it convenient to have special as-

pects of its business conducted by a subsidiary. A manufacturing business might have a separate sales corporation, or a special corporation for its foreign trade. If it engaged in the transportation of its own materials, it might carry on that part of its business by a separate corporation, or by more than one. A business may be conducting experiments, and have a subsidiary for research and development of processes of manufacture or new products. Each situation involving the formation of subsidiaries rests on its own reasons.

ACQUISITION OF GOING CONCERN — TAX PROBLEMS

Occasions arise when a corporation, instead of assembling assets and developing new business, desires to obtain assets already assembled and in use in a going concern.

Business men and their counsel must consider every transaction, even simple ones, from the viewpoint of their result in taxation. When they enter into a matter as large and complicated as that of a corporate acquisition of another corporate enterprise, the tax problem demands the most careful examination. If the interested parties do not follow exactly the right path, they may find themselves involved in the most unpleasant consequences.

When our National Government obtained the Constitutional power to tax incomes, it adopted a policy of including as income, not only those profits made in the ordinary course of business, but also profits on capital transactions. Possibility of such profits appears during periods of high price levels, when generally business activity reaches its maximum, and actual incomes, outside of capital transactions, afford an adequate tax base.

Taxing the profits on capital transactions can have no element of justice unless the tax law allows the deduction of losses on like transactions. Even when the statute permits the deduction, it does not do justice, if limited to the income term of a single year. In some periods we have only profits; in other periods we have only losses.

During a time of low business activity and depressed price levels, the possibility of capital profits disappears, and only the possibility of loss exists. When that part of the tax base, which consists of income, is at its lowest, there are no gains on capital transactions; and a deduction of capital losses would still further reduce the base.

Such a tax policy, of including profits on capital transactions as income, impedes the free flow of business. It checks individual liquidation at a time of high price levels, when it ought to take place as a market corrective. Men are reluctant to sell, and pay the taxes on profits, which increase the rate by raising the income into higher surtax brackets.

Though this work is no place for a general discussion of the theory of taxation, it is necessary to mention at least the fact of taxation of profits on capital transactions, because, as we have said, those who consider carrying through a disposition of the control or ownership of one corporate enterprise to another must consider the tax problem involved, and, if it is not prohibitive, shape the transaction accordingly. State tax statutes, as well as the Federal, may affect it. Each situation presents its state of facts. No attempt will be made here to present an actual application of the Federal or any other tax statute.

When is an asset liquidated so that a profit or a loss is taken? A sale for cash settles the matter. That establishes a recognizable point of rest or stop. Cash gives its possessor a choice of consumption, or of entering on new risks; and if he does not consume, he has a choice among new risks. But if he exchanges one property for another has he reached such a rest point that gains should be computed for purposes of taxation? We will only quote the administrative regulations, under the complex provisions of the Federal statute, most nearly affecting the matter of corporate expansion through the acquisition of control or ownership of another corporate enterprise, just to place before the reader some of the considerations involved.

The statute itself is far from clear. It is not quoted. The regulations are clearer, but inadequate.

ART. 574 (REG. 77) EXCHANGES IN CONNECTION WITH CORPORATE REORGANIZATIONS

The Act provides that no gain or loss shall be recognized if, in pursuance of a plan of reorganization, stock or securities in a corporation a party to a reorganization are exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization, or if, in pursuance of a reorganization plan, a corporation a party to a reorganization exchanges property solely for stock or securities in another corporation a party to the reorganization. If two or more corporations reorganize, for example, by —

(1) The merger of the X Corporation into the Y Corporation,

(2) The consolidation of the X Corporation and the Z Corporation into the Y Corporation, a new corporation,

(3) The acquisition by the Y Corporation of a majority of the voting stock and a majority of the total number of shares of all other classes of stock of the X Corporation or of substantially all of the properties of the X Corporation, or

(4) The transfer by the X Corporation of a part of its assets to the Y Corporation where immediately after the transfer the X Corporation or its shareholders or both are in control of the Y Corporation —
then no taxable income is received from the transaction by the X Corporation or the Z Corporation if the sole consideration received by the corporations is stock or securities of the Y Corporation; and no taxable income is received from the transaction by the shareholders of either the X Corporation or the Z Corporation if the sole consideration received by the shareholders is stock or securities of the Y Corporation.

If a reorganization is accomplished by the transfer by the X Corporation of a part of its assets to the Y Corporation in exchange for the stock of the Y Corporation and the X Corporation distributes to its shareholders the stock of the Y Corporation, no gain to the shareholders from the receipt of such stock is recognized. (See article 576.)

Provision is made in the Act for cases in which gain to the shareholders is recognized, in connection with the reorganization, through the receipt of cash or property other than the stock of a corporation a party to the reorganization. (See article 575.)

Records in substantial form, showing the basis of the stock or property exchanged and the amount of property or money received in exchange, must be kept to enable the determination of gain or loss from a subsequent disposition of the stock or property received in exchange. (Art. 574, Reg. 77.)

ART. 575 (REG. 77) EXCHANGES IN REORGANIZATIONS FOR STOCK OR SECURITIES AND OTHER PROPERTY OR MONEY

If stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged for stock or securities in such corporation or in another corporation a party to the reorganization and other property or money, the gain, if any, to the recipient will be recognized in an amount not in excess of the sum of the money and the fair market value of the other property. No loss from such an exchange will be recognized. (See section 112(e)). If a dis-

tribution of property or money in the course of a reorganization is otherwise within the provisions of this paragraph, but has the effect of the distribution of a taxable dividend, there shall be taxed to each distributee (1) as a dividend, such an amount of the gain recognized under this paragraph as is not in excess of the distributee's ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913, and (2) as a gain from the exchange of property, the remainder of the gain recognized under this paragraph.

Example (1): A, in connection with a reorganization, exchanges in 1932 a share of stock in the X Corporation, purchased in 1925 for $100, for (a) a share of stock in the Y Corporation, a party to the reorganization, which has a fair market value of $90, and (b) $20 cash. The gain from the transaction, $10, is recognized and taxed to A. See article 597 for the basis for determining gain or loss from a subsequent sale.

Example (2): The X Corporation has a capital of $100,000 and earnings and profits of $50,000 accumulated since February 28, 1913. The X Corporation in 1932 transfers all its assets to the Y Corporation in exchange for the issuance of all of the stock of the Y Corporation and the payment of $50,000 in cash to the shareholders of the X Corporation. A, who owns one share of stock in the X Corporation, for which he paid $100, receives a share of stock in the Y Corporation worth $100 and in addition $50 in cash. A will be liable to the surtax on $50.

If, in pursuance of a plan of reorganization, property is exchanged by a corporation a party to a reorganization for stock or securities in another corporation a party to the reorganization and other property or money, then, if the other property or money received by the corporation is distributed by it pursuant to the plan of reorganization, no gain to the corporation will be recognized. If the other property or money received by the corporation is not distributed by it pursuant to the plan of reorganization, the gain, if any, to the corporation from the exchange will be recognized in an amount not in excess of the sum of the money and the fair market value of the other property so received which is not distributed. In either case no loss from the exchange will be recognized. (See section 112(e)). (Art. 575, Reg. 77).

As to what constitutes a reorganization we will quote so much of the act as gives a definition:

As used in this section and sections 113 and 115 —

(1) The term "reorganization" means (A) a merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or substantially all the properties of another corporation), or (B) a transfer by a corporation of

all or a part of its assets to another corporation if immediately after the transfer the transferor or its stockholders or both are in control of the corporation to which the assets are transferred, or (C) a recapitalization, or (D) a mere change in identity, form, or place of organization, however effected.

(2) The term "a party to a reorganization" includes a corporation resulting from a reorganization and includes both corporations in the case of an acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation.

(j) *Definition of control* — As used in this section the term "control" means the ownership of at least 80 per centum of the voting stock and at least 80 per centum of the total number of shares of all other classes of stock of the corporation.

EXPANSION THROUGH STOCK PURCHASE

Acquisition of stock presents one of the simplest methods of gaining control of an established corporate enterprise.

Ordinarily, at least control is sought. It is believed that the business can be made in some way to fit in with the enterprise seeking to acquire it. Control is necessary to assure the fitting. If the stock of the business sought is fairly active in the security market, the corporation desiring it can make market purchases. An investment interest may be obtained in this way, but it is difficult to gain control through market purchases. As the buyer absorbs the floating or market stock, as opposed to the stock held for investment, each transaction tends to put the market price up.

More frequently an enterprise obtains control by private arrangement with large stockholders of the business sought. The offer of the purchaser may be to buy stock for cash. It is likely, however, to be a proposal to exchange stock of the acquiring corporation, for stock of the corporation to be acquired, on terms considered to represent an equivalence in values. The large stockholders of the enterprise sought as a subsidiary believe, with those in control of the corporation seeking to acquire it, that such advantages will accrue from the coördination of the two businesses as will make the transaction profitable. When these large holders have accepted the offer of exchange, the same offer may be made to the other stockholders. If a fifty-one per cent or larger interest is sought, it is quite possible that the large stockholders who

are willing to enter into the transaction can deliver the required amount of stock. Unless they can, the agreement with them may be made conditional on enough others joining to give the stipulated percentage. Let us consider a hypothetical transaction of Corporation A acquiring control of Corporation B under the following conditions:

CORPORATION A

Assets	
Current	$ 6,000,000
Fixed	17,000,000
	$23,000,000
Liabilities	
Current	$ 2,000,000
Stock	20,000,000
Surplus	1,000,000
	$23,000,000

Earnings available for stock have averaged $2,000,000 for the past five-year period.

CORPORATION B

Assets	
Current	$1,000,000
Fixed	4,300,000
	$5,300,000
Liabilities	
Current	$ 200,000
Stock	4,000,000
Surplus	1,000,000
Profit and loss	100,000
	$5,300,000

Earnings available for stock have averaged $600,000 for the past five-year period.

From these statements it appears that Corporation A has been earning $10 a share on its stock, and Corporation B $15 a share. Assume that the parties to the negotiations for the exchange of shares see possibilities, under coördination of the two enterprises, of more profitable utilization of the two plants. Stock of A is traded in at about $102 a share. However, since there is no active market in the stock of B, relative market prices are not of assistance in arriving at the terms of a bargain. Let us assume that

from these and other considerations, it is proposed that Corporation A acquire stock of Corporation B on the basis of one and one-half shares of A stock for one share of B stock, and that A has sufficient authorized and unissued stock to issue for the purpose.

The holders of sixty per cent of B stock join together and privately agree to accept the offer of Corporation A to make the exchange on this basis. When the offer of exchange on the same terms is made to all the other stockholders of B, the owners of twenty per cent more of the B stock join in the acceptance. Carrying out the agreement, Corporation A becomes the owner of 32,000 of the 40,000 outstanding shares of B, and issues 48,000 shares of A stock therefor, increasing the outstanding A shares to 248,000.

On this method of acquiring control, however, Corporation A still has the problem of the owners of twenty per cent of the stock of B, who did not agree to the plan. The situation is somewhat delicate, both for Corporation A and for the minority stockholders of B. Will all the plans of A for its subsidiary be in the interest of these minority stockholders of B? By electing the board of directors of B, the A Corporation controls the policies of B. Very likely a majority of directors of B will also be directors of A. Occasions for transactions between A and B may arise. Even if they do not, a policy in the best interest of the minority stockholders of B may not be in the best interest of A, in spite of the fact that A has so large a holding of B stock. The minority stockholders of B have only the possibility of an action for fraud with which to protect themselves. On the other hand, A may be constantly hindered in its management of B with considerations of the propriety of a proposed course of action.

SALE OF ASSETS OF ONE CORPORATION TO ANOTHER

Anticipating these difficulties of a minority interest, the A Corporation may wish, if possible, to effect a transaction that will avoid them. Instead of acquiring stock of the B Corporation, the management of the A Corporation may work out with the majority stockholders of B Corporation a plan, to which two-thirds or more of the B stockholders agree, on condition that enough more stockholders join them to make eighty per cent, under which they will vote for a sale of the B assets to A, and thereupon exchange their stock as before, one share of B stock for one and one-half of A stock.

Let the price to be paid for the assets be $6,000,000, payment of liabilities, of costs of carrying through the plan, and settlement with any stockholders of B who may not assent. We will assume that eighty per cent of the B stockholders agree to this plan.

The A Corporation makes an offer to the B Corporation to purchase its assets, etc., for $6,000,000; and the directors of the B Corporation accept, subject to the approval of stockholders. At the stockholders meeting, the eighty per cent who have joined in the plan approve of the sale, but the non-assenting twenty per cent do not vote for it.

Thereupon the assenting B stockholders exchange their B stock for A stock in accordance with the plan, so that the A Corporation becomes the owner of 32,000 shares of B stock. Corporation B executes proper conveyance of its realty, bill of sale of its chattels, and an assignment of its accounts receivable. It also carries through proceedings for dissolution; and in liquidation conveys its assets to A, receives from A $1,200,000 in cash for distribution to its minority stockholders, $200,000 further cash to settle B's liabilities as ascertained, and a surrender of the 32,000 shares of B stock for cancellation.

MINORITY STOCKHOLDERS' APPRAISAL ACTION

In the meantime the non-assenting stockholders of B have instituted a proceeding for the appraisal of their stock. Appraisers appointed pursuant to the statute find the value of stock to be $155 a share, so that the A Corporation will have to add $40,000 to the $1,200,000 already paid over for the satisfaction of the minority stockholders of B. They send their certificates for payment to the designated bank (which we will say is the transfer agent for B stock), to which the directors of B, as trustees in dissolution, pay over their $1,200,000; and the A Corporation pays $40,000, making a total fund of $1,240,000, or $155 a share for each of the 8000 non-assenting shares of the B Corporation. The bank pays this out on presentation of the certificates.

ALTERNATIVE PLAN

Corporation A might have made an offer to B to purchase the B assets for 60,000 shares of A stock and assumption of the B liabilities. In carrying through the transaction, the B Corporation

could dissolve and distribute to its stockholders the A stock it receives on transfer of the B assets. It may be taken as a general principle that an objecting shareholder cannot be forced to accept anything but cash in liquidation. However, as before, a nonassenting stockholders' appraisal proceeding might be taken.

LIABILITIES OF ACQUIRED ENTERPRISE

Any funded debt of an enterprise to be acquired may present a difficulty. If the bonds are redeemable, and cash can be provided to pay them, that would dispose of the matter. Though it is easy to say the words "pay them," it may not be easy, or even possible, to procure the cash. And the bonds may not be redeemable.

When considering the topic of the corporation mortgage, we saw the arrangement for the release of liability of the obligor on assumption of the debt by a corporation acquiring all the assets. Excepting for such a release, the vendor corporation could not properly liquidate, for it would still have the contingent liability.

Regarding the current debt, the vendee corporation may not care to make a general assumption. It might increase the purchase price, and leave the directors of the vendor corporation to settle with its creditors. Probably the buying corporation would not assume the liabilities generally anyway, but only those shown on the books. Responsibility for ascertaining those not shown should rest with the directors of the seller corporation; though some may not be immediately liquidatable, buyers are not likely to assume obligations of indefinite amount; though, to be sure, in our example we had them take a chance on settling with minority stockholders.

MERGERS

Our discussion of expansion through the acquisition of control or ownership of a going concern has considered ownership by process of consolidation, i.e., purchase of assets and dissolution of the vendor. Corporation statutes provide another method. By the appropriate proceeding through director-stockholder action, and filing with the State authority, the identities of the two corporations may merge into one, which continues the ownership of assets and is responsible for the liabilities of both.

For such procedure, the two corporations should be, and, indeed, might have to be, the creations of the same State. One State can

CHAPTER XXII

Expansion as Affected by the Future Acquired Property Clause. And Leases as a Means of Extending an Enterprise.

Holding Companies.

Corporate tangible assets have no substantial value except as part of a going concern. One who lends to an enterprise may well seek as security all the physical things the business uses in its production or service. He needs also earning power as the essential value, and seeks assurance through his contractual control over the assets, which produce earnings, that he will have the benefit of whatever capacity may exist for the production of income.

PROTECTION OF THE CREDITOR BY GOING CONCERN VALUES

As long as the borrower continues solvent, the lender has no direct benefit from security. The solvent borrower pays its debts. A lender requires protection in the situation which arises on insolvency. Then, though income is insufficient to meet obligations, the debtor enterprise may, nevertheless, still have some income, or an expectation of it. Going concern values exist.

EXAMPLES OF FAILURE OF THE CREDITOR TO PROCURE THE PROTECTION OF GOING CONCERN VALUES

Let us illustrate the idea by examples of what might possibly happen. The A Manufacturing Company has a plant at X, which it mortgages to secure a bond issue. But the mortgage does not contain any provision that the lien shall extend to future acquired

property. After a while the corporation decides that it would be advantageous to have a plant at Y. It finances construction of the new plant by giving a first mortgage on this additional asset. In the course of time the company shifts most of its production to Y, and substantially abandons its plant at X.

Capital represented by the plant at X now has essentially no value; yet the company must go on paying the wage of the idle asset to the extent of the interest on the bonds it secures. Later the business becomes insolvent. The X and the Y bondholders both foreclose their mortgages. But the Y bondholders have all the real security. They have whatever earning power the going concern may have. Bondholders secured by the X mortgage have only a plant which has been found not economically useful.

As another illustration of the same thing, let us assume that a railroad has financed by giving a mortgage without a future acquired property clause. Later it straightens out its line and reduces grades by building an extensive cut-off, which throws a hundred miles or more of its old line almost out of use. The corporation places a first mortgage on the cut-off. Then, on insolvency, the bondholders secured by the cut-off can take the asset out of the enterprise if the holders of bonds on the original line do not come to terms.

FUTURE ACQUIRED PROPERTY CLAUSE AN ENDEAVOR FOR PROTECTION IN GOING CONCERN VALUES

In an endeavor to prevent such situations, lenders to corporate enterprises, when taking mortgage security, insist that the mortgage contain a covenant that it covers not only all property the corporation now owns, but also all property it may acquire in the future. Further, the mortgagor covenants that it will execute and deliver any instruments, and do any acts, necessary to cause such future acquired property to come under the mortgage.

We will not delay to consider the legal problems involved — the possible rights of a creditor attaching such future property before the owner has delivered a supplemental instrument expressly placing it under the mortgage, etc. It is enough for our purpose to say that, if title to property is actually taken in the future, the covenants are substantially effective for the purpose intended.

So creditors have invented their instrument of warfare in the

economic struggle. They seek to draw to themselves all the fundamental credit values of an enterprise. If they succeed, the owners will not be able to give equally good security to other creditors. In the case of the A Manufacturing Company, it financed its new plant at Y by giving a first mortgage on it. The company's general credit, plus the specific security, were good enough to induce the lender to part with his money. Such a security as a second mortgage on the entire assets might not have been enough. Owners naturally seek weapons to counteract the operation of the future acquired property clause. And in the armory of the law the owners find them.

ENDEAVOR OF THE DEBTOR TO RETAIN THE CREDIT VALUES OF FUTURE ASSETS

Let us now assume that the original mortgage of the A Company does contain a covenant that the mortgage shall extend to all future acquired property. The owners want to put up the new plant at Y. They go to investment bankers and ask them to buy a bond issue secured by a general mortgage on the existing assets at X and those to be acquired at Y. They foresee that the operation of the future acquired property clause of the existing mortgage will extend its operation so that it will become a first mortgage on the new assets. So in this case the term "general mortgage" is synonomous with "second mortgage."

On looking into the situation, the bankers say that they think such a second mortgage does not give the bonds a good enough credit. They say further that they would take the bonds if the corporation could give them the security of a first mortgage on the new assets at Y. The future acquired property clause insisted on by the X bondholders does not present an insuperable obstacle. After discussion, the representatives of the corporation and the bankers come to an understanding about what shall be done, and the bankers agree to take the bonds, guaranteed by A, at 90.

DEBTOR'S AVOIDANCE, THROUGH FORMATION OF SUBSIDIARY CORPORATION, OF EFFECTS OF FUTURE ACQUIRED PROPERTY CLAUSE

The management of the A Corporation causes the organization of the B Corporation, to which it pays enough cash to buy the needed land at Y, and receives therefor the shares of the capital stock of

B. Since the A Corporation is the only holder of B stock, some of the A directors become the directors of B. They carry through the proceeding to mortgage all the B assets to secure an issue of $1,000,000 of bonds of the B Corporation.

It will take nearly a year to complete the new plant ready for operation. However, the bankers could hardly agree now that they would pay 90 for bonds which they will not receive for a year. If they are committed they must have bonds delivered to sell within the time during which they are prepared to take the risks of the market. They may be ready to chance what market conditions will be three months away, but not a year away.

FORM OF TRANSACTION

So the mortgage contains a provision that the trustee may authenticate and deliver, on the order of the corporation, the entire $1,000,000 of bonds on receiving $900,000 in cash to hold and pay under the terms of the mortgage. They are that the trustee shall pay cash over to the corporation from time to time as construction progresses. Since we are interested here only in the use of a subsidiary corporation to avoid the credit effects of a future acquired property clause in a mortgage of the parent company, we will not delay to go into the methods of protecting these cash payments over to the B Corporation.

On completion of these arrangements, the bankers can perform on their contract with the A Corporation at a closing, at which they pay $900,000, and receive $1,000,000 face amount of B bonds carrying the guarantee of A endorsed on them. Since A as the sole stockholder of B gets the entire benefit of the credit value, it may properly give the guarantee. The bankers can now go ahead and sell.

Investors buying these bonds have the security of the land and the deposited cash. As the cash is expended, they have the security of the plant. Though the B Corporation, principal obligor on the bonds, has no present income, investors have the benefit of the earnings of the A Corporation, through the endorsement of its guarantee on the bonds.

The B Corporation, a mere pocket for the A Corporation, has available $900,000 in cash with which to go ahead with the construction of the new buildings and the installation of machinery. If counsel are fearful that under these circumstances the separate

entities of the two corporations may not be adequate protection, the corporate group for B can be varied sufficiently to make it a clearly distinguishable group.

POSSIBLE DISSOLUTION OF SUBSIDIARY AND ACQUISITION OF ITS ASSETS

Maybe, after completion of the B plant, the A Corporation will find it entirely convenient, or even desirable, to continue the situation of parent and subsidiary corporations. If not, A can cause B to transfer all its assets to A and dissolve. In that event A acquires the B assets subject to the mortgage, which provided that the liability of B as obligor on the bonds should cease on the acquisition of all the assets of B by another corporation assuming payment. Under the circumstances, the assumption does not really increase the liability of A, which has already guaranteed payment.

CARRYING THROUGH THE TRANSACTION IN ANOTHER WAY BY THE USE OF COLLATERAL BONDS

Bankers and the A Corporation might arrange to get the desired results in a different way. What the bankers want is the general credit of the existing power of A to earn, and the specific security of the assets of B. Instead of buying the bonds of B, guaranteed by A, they might have bought bonds of A secured by a pledge of the bonds of B as collateral.

If the transaction is carried through in this form, the B Corporation will mortgage its assets, and the trustee authenticate and deliver its bonds on receiving $900,000 in cash, all as before. Now, however, instead of the A Corporation endorsing its guarantee on these bonds, the trustee, on instructions from the B Corporation, will deliver them to a trustee under a trust indenture executed by A. This indenture provides that the trustee shall hold these bonds as collateral security for $1,000,000 of A bonds to be issued under the indenture.

These are the bonds which the A Corporation has sold to the bankers. They carry the essential security the investors need: the general credit of the going concern A, and the specific security of a "virtual" first mortgage on B. To be sure, the A bonds do not have the security of a direct first mortgage on the B assets.

But on default on the A bonds, the holders can reach the B bonds, and through them foreclose on the B assets.

USE OF COLLATERAL BOND ISSUE IN GENERAL PLAN FOR EXPANSION

For a single transaction, it makes little difference whether the business takes the form of a guarantee on the bonds of the mortgagor, or the form of a direct obligation, with the bonds of the mortgagor as collateral. For a plan of continued expansion, however, a corporation may make advantageous use of the collateral form.

We will assume that a corporation anticipates that it will need to finance additional assets, not once only, but from time to time. It might just repeat the transaction each time. On doing so five times it would have five separate bond issues outstanding. We will say that they would be for $2,000,000 each.

Instead of having a series of issues, the corporation can plan to have a single issue. Let it authorize, say, $15,000,000 of bonds, and have the indenture provide that the trustee shall authenticate and deliver bonds from time to time on the deposit of collateral. The provision might be for the issuance of a $1000 collateral bond on the deposit of each $1000 bond secured by first mortgage on property costing twice the face amount of the bonds issued against it. On such a provision the corporation would have to have the means of doing the equity financing; that is, of providing the other half of the cost of the additional assets, plus any discount at which the collateral bonds might be sold.

Then, as the corporation expanded by each addition of assets, through a subsidiary corporation, costing $4,000,000, the subsidiary could issue $2,000,000 of its bonds. These could be deposited under the collateral indenture of the parent company, which could bring out $2,000,000 of its own bonds. After it had repeated this operation five times, it would have $10,000,000 of its collateral bonds outstanding. A $10,000,000 issue enjoys a much better market than a $2,000,000 issue. Since marketability is an element of value, the corporation will be able to sell its bonds of the uniform issue more advantageously than it could those of five smaller issues.

Naturally the value of the collateral issue would depend, in considerable part, on the assurance given the investor that the

authority for additional issuance would not impair his security. When he buys bonds of a closed issue he knows just what his security is. The collateral indenture provision we have taken, that the cost of the assets mortgaged to secure the pledged bonds must be at least twice as great as the debt, covers the situation.

Just as in the case of the single transaction, with which we began, the expanding enterprise may either continue the existence of the subsidiaries, or may cause their dissolution as having served their purpose.

IF ASSETS ARE TO BE KEPT FREE FROM THE OPERATION OF A FUTURE ACQUIRED PROPERTY CLAUSE, TITLE MUST BE KEPT CLEARLY OUT OF THE PARENT COMPANY

Wording of the future acquired property clause makes it inclusive of everything but current assets. Any permanent property which the corporation may acquire comes under the operation of the clause. The transaction should be so shaped that the parent company never gets title to the bonds of the subsidiary, which are being pledged as collateral; indeed, so carried through that nothing suggests any color of title.

OTHER DEVICES FOR PREVENTING THE OPERATION OF THE FUTURE ACQUIRED PROPERTY CLAUSE

Any device which will clearly keep out of the expanding corporation the title to the capital assets used in the business presumably will serve to prevent the operation of a future acquired property clause. We will see the use of a lease, or a conditional sale, without the utilization of a subsidiary, when we come to consider the financing of railroad equipment. This has such special aspects, however, that we will defer consideration of it until a subsequent chapter.

SUBSIDIARIES MAY BE RETAINED YET SINGLE OPERATING UNIT CREATED BY MEANS OF LEASE

One objection to retaining the subsidiaries, after they have served their purpose of keeping assets out of the parent corporation long enough for a mortgage to attach, may be the nuisance of operating the additional property through the machinery of a

separate corporation. For the enterprise must go through all the corporate motions. It must keep a set of books for each corporation. Employees must be on the pay roll of the subsidiary. It must declare dividends to make its earnings available to the parent concern. All this puts a good many obstacles in the course of operation of what, for all the different corporations, is in fact one enterprise.

By taking a lease of the assets of the subsidiary, the parent company may operate the entire property as a single unit. If the parent company owns all the stock of the subsidiary, the lease may be on the very simple terms of a rental sufficient to pay the taxes and bond interest of the subsidiary. Any additional rent would merely be returned in dividends to the parent company. Where there are any stockholders other than the controlling corporation, the terms of the lease must be equitable to the minority interest.

Possession of the leased property passes into the hands of the lessee. Though title remains in the lessor, the possession of the lessee enables it to use the assets as an integral part of the expanding enterprise. For purposes of operation the situation is as simple as it would be if the lessee owned the assets.

Since the lessor continues as a corporation, it will have to perform all its corporate duties to the State which created it — will have to pay the franchise tax, and render the required reports. If the subsidiary were organized solely for the purpose of preventing the operation of a future acquired property clause these burdens may cause its dissolution, and a transfer of its assets to the parent company.

LEASES AS A MEANS OF ACQUIRING THE USE OF GOING CONCERN ASSETS

In the preceding chapter we discussed the process of acquiring ownership of the assets of a going concern, or control of them through ownership of the stock of the concern owning the assets. We presented the transactions as effected entirely or in greater part by an exchange of securities. If the parties could not arrive at a bargain on this basis, and the owners were willing to dispose of their property, if at all, only on cash terms, the acquisition would require financing. Raising dollars may not be any easier for a corporation than for an individual.

Even though the expanding enterprise might find it possible to procure cash funds, the cost may be such as to be avoided, if possible. Yet, as we assume, the owners of the going concern are unwilling, by an exchange of stock, to cast their lot in with that of the owners of the expanding enterprise. These may offer its general bonds in exchange for the stock of the assets of the going concern, and its owners still be unwilling to accept. By acceptance they will lose ownership of their asset. If the acquiring concern fails they lose values they have received in exchange. By selling property subject to a purchase money mortgage, to be sure, the vendors can transfer title, and still, through foreclosure, get the original property back in the event of the failure of the buyer to make the agreed payments.

However, another possibility presents itself. The management of an expanding enterprise may be able to obtain the use of going concern assets on the terms of a lease. Then, without any of the problems of foreclosure, the owners of the property so acquired for use can take it back on failure to receive the agreed compensation.

Such leases have been made in the railroad field for long periods of time, as ninety-nine years. A term of that length comes close to the purchase of an asset with an obligation of the vendee. Simply, with the lease, title does not pass; so the lessors have their even stronger control than they would have if they sold the property and took a mortgage back to secure the purchase price.

Long term lessors need especially to be protected against loss by depreciation. So the lease will contain elaborate provisions for maintenance. The fact that maintenance can offset depreciation in the railroad field perhaps explains why the lease has been used there, and generally not in other kinds of business.

Rent, in railroad leases, is generally expressed in terms of payment of taxes on the lessor, guaranteeing interest on its funded debt, and a fixed rate of dividend on its stock. Though approximately a guarantee, the rent may take the form of a sum paid to the lessor sufficient to meet these items. Such leases are the most frequent origin of guaranteed stocks.

Expansion by lease avoids the expenses and difficulties of financing by sale of capital securities. The device has been used extensively in the development of our railroad systems out of the original independently constructed and operated units.

LEASES IN RECEIVERSHIP

As long as the lessee remains solvent and pays the rent, we have no problem. Devices of purchase money mortgage, conditional sale and lease, have been developed to protect those who accumulate capital and subsequently turn it over to others to use on condition that, if they do not pay the agreed compensation, those who supplied the capital will get it back, directly in the case of the conditional sale or lease, and indirectly, by foreclosure, in the case of the mortgage. If a lessee gets into difficulties resulting in the appointment of a receiver, the latter has his election, within a reasonable time, of either adopting the lease and paying the agreed compensation, or of turning possession of the asset back to the lessors.

It is not property belonging to the insolvent corporation to be run through the general liquidation mill. The lessors get either their property or their compensation. If they do not get their compensation, there has been a breach of the contract of lease. We will consider this aspect of the situation further when we come to the subject of corporate reorganization.

JOINT CORPORATE FINANCING

Railroad terminals present the typical case of joint corporate financing. Two or more roads unite in the construction, operation, and use of a single terminal property. They cause the organization of the terminal corporation, and enter into agreements with it for the use of its facilities. Though the entering roads, as among themselves, pay pro rata to their use, their agreement is such that they jointly assure the payment of the terminal company's securities. Since the terminal itself is a vital part of the operating properties of the railroads, the securities of some of these terminals enjoy a high investment standing.

HOLDING COMPANIES

Holding companies do not present any addition to the corporate ideas already discussed. We have seen the process of expansion through formation of a subsidiary; and by the acquisition of a going concern through purchase of its stock making it a subsidiary. So far, however, this has mostly shown the situation of

an operating company becoming a parent corporation. Obviously, with statutes permitting a corporation to acquire stock of another corporation, and not requiring the ownership corporation to engage in some construction or service enterprise of its own, we may have a company which does no business but hold the stock of other companies. Though the holding company does not add to the stock of corporate ideas, it does extend the field of their activity. Let us consider some of these extensions.[1]

HOLDING COMPANIES TO ASSEMBLE PROPERTIES FOR ULTIMATE PHYSICAL CONSOLIDATION

We have already mentioned the possible use of a series of corporations for an enterprise, as a railroad, in the construction process, with an expectation that when the construction is completed the assets will be transferred to one corporation, and the others dissolved. Though such a process does not necessarily involve the use of a holding company to tie the several corporations together, one might be used. Enterprisers may utilize a holding company as a convenient means for assembling the ownership of a series of going concern operating companies, with the intention of consolidating them physically when they have all been acquired through stock purchases. Such a course might especially be desirable if the assembling were likely to run over a period of years.

HOLDING COMPANIES AS A FINANCING DEVICE TO ASSEMBLE PROPERTIES: THE REVOLVING FUND

The holding company offers a mechanism for the operation of the revolving fund idea in financing, and adds the advantage of creating large uniform issues of securities for the market. Let us assume a corporation formed for the purpose of being a holding company, and starting with $1,000,000 of capital. It uses this fund to acquire the stock of a going concern. Then it pledges its asset of this stock as collateral to raise additional funds. We will assume that the company raises $750,000 in this way. On increasing its own capital stock by $250,000 it proceeds to acquire

[1] For a full consideration of holding companies see James C. Bonbright and Gardiner C. Means, *The Holding Company*. McGraw-Hill Book Company, New York, 1932.

$1,000,000 of stock of another going concern. And so on indefinitely.

Promoters have used this financial device in the field of railroads. In latter years they have especially used it in the field of utilities. For a time they used it in the development of chain banks. Its abuse in the creation of unsound situations has greatly added to the economic difficulties consequent upon the financial break of 1929. Adoption of any possible just means to prevent such abuses in the future would be a great social gain. We are passing with a few words a matter that deserves extensive treatment.

Those who so abuse the system of private ownership of property are its worst enemies. Their conduct is a betrayal of the system. They strongly incite society to abandon it in disgust, without adequate consideration of whether the fire may not be worse than the frying pan. To be sure, their operations would not be possible except through the responsive greed of other members of the community. But the promoters have occupied the position of leadership. Some have not lived up to their responsibility.

UNIFORM FINANCING

In our discussion of the use of collateral bond issues secured by the pledge of bonds of subsidiaries we have already considered the advantages of uniform financing. A holding company offers the same advantages of large uniform issues in acquiring and subsequently financing subsidiaries. It is immaterial for this purpose whether the device be holding company bonds secured by bonds or stock of the subsidiaries, or be simply unsecured debentures or stock of the holding company. In any of these ways the holding company creates its relatively large uniform issues, with their market advantage, and through them procures the funds with which it effects its purchases or finances the properties acquired.

INTERCORPORATE RELATIONS

Intercorporate relationships of the financing of the subsidiaries by the holding company, of management contracts, of methods of accounting, open up further opportunities for skulduggery. If the holding company really owns the subsidiary lock, stock, and barrel, owns all its shares, and it has no bonds or other creditor

obligations, these manipulations would probably, with one exception, be harmless enough. Such absolute ownership situations seldom exist. There are minority stockholders of the subsidiaries. And improper operations may injure not only minority stockholders, but creditors.

INTEREST OF THE STATE IN INTERCORPORATE RELATIONSHIPS

Even if the holding company has an absolute ownership of its subsidiaries, manipulation of intercorporate relationships may be aimed at the interest of the State, and be directed at creating a tax situation, perhaps quite legitimately. In the case of a utility enterprise, it may be aimed at creating a show of costs in connection with rate making, through the diversion of revenue, under the guise of costs, into the treasury of an unregulated holding company, or possibly into a parasitic corporation.

Management contracts have especially been attacked on this ground. We have elsewhere remarked on the propriety, under general corporate principles, of a board of directors, even with the approval of stockholders, divesting itself of management. It can be done by leasing the corporate property, but query: if it can be done by contractual agreement otherwise. This is not saying that any of the utility contracts amount to divesting management from the directors.

PYRAMIDING FOR CONTROL

Our remarking on the use of the revolving fund idea through the holding company should indicate the possibility of the use of the holding company in pyramiding for control. Let us consider a simple illustration, and assume that operating companies A, B, C, D, and E each have $5,000,000 of stock and $15,000,000 of bonds, representing like amounts of asset values, an aggregate of $100,000,000 of assets.

Promoters organize Company R and issue its stock par for par, in exchange for one-half of the stock of each of the operating companies. Of course it is immaterial, for purposes of the illustration, whether the stock of R is exchanged directly for the stock of the operating companies, or is sold and the proceeds used to purchase the operating company stock. Company R

now has outstanding $12,500,000 of its stock, for the moment in the hands of the promoters, its ownership financed, we will say, by temporary loans.

Now the promoters organize Company S, which issues $6,250,000 of its stock in exchange for a like amount of the stock of R. They then sell the other $6,250,000 of R stock and $3,125,000 of S stock. Retaining $3,125,000 of S stock, they control the $100,000,000 of assets of the operating companies. As we shall see, they might intensify the process by the use of creditor securities.

PYRAMIDING FOR EQUITY PROFITS

Let us carry the pyramiding process one step further, and consider it as a device not only for control, but for increasingly hazardous equity profits. To show the process we must now make an assumption of a rate of earnings, and will assume that the operating companies are earning at the rate of seven per cent on their capital values, or $7,000,000 a year, and that their bonds all carry five per cent interest, creating an aggregate charge in the total of $75,000,000 of bonds of $3,750,000, leaving $3,250,000 for the stock.

Instead of issuing $12,500,000 of stock of R Company, the promoters issue $10,000,000 of six and one-half per cent bonds and $2,500,000 of stock. They sell the bonds and $1,250,000 of the stock. The other $1,250,000 of R stock they put in Company S, which issues a like amount of stock. The promoters sell $625,000 of S stock. Now they control the $100,000,000 of operating company assets with an ownership of $625,000, or a little more than one-half of one per cent. Though these figures are not presented as representing anything but a principle, they are hardly more fantastic than some that have been created. Pyramiding companies, formed in a period of increasing earnings, are liable to collapse in a period of declining profit.

Setting up statements for the several companies, we have:

CONSOLIDATED STATEMENT OF A, B, C, D, AND E

Income Account

Earnings for capital	$7,000,000
Bond interest	3,750,000
Available for stock	3,250,000
Per cent on stock	13%

R

Income Account

Dividends received of 13% on $12,500,000 stock of A, B, C, D, and E, $1,250,000 of each	$1,625,000
Interest paid on $10,000,000 bonds at 6½%	650,000
Available for payment of dividends on $2,500,000 of stock	975,000
Per cent available for stock	39%

S

Income Account

Dividends received on $1,250,000 of R stock	$487,500
Available for dividends on $1,250,000 of S stock	487,500
Per cent available for stock	39%

Assume now that earnings on capital used in operating drop from seven per cent to five per cent, and we have:

Consolidated Statement of A, B, C, D, and E

Income Account

Earnings for capital	$5,000,000
Bond interest	3,750,000
Available for stock	1,250,000
Per cent on stock	5%

R

Income Account

Dividends received of 5% of stock of operating companies owned	$625,000
Interest on $10,000,000 of bonds at 6½%	650,000
Deficit	25,000

So there will be a default on the R bonds, which will wipe out the equity of the R stock, and that will wipe out the S stock. The operating companies will remain intact. Though our figures may seem almost grotesque, they are such that this hypothetical situation almost scrapes through. Some of the actual situations created have gone down like the proverbial row of dominoes on end.

SOCIALLY UNDESIRABLE USES OF HOLDING COMPANIES

It is the belief of the writer that holding companies to pyramid for control, or for equity profits, do not serve any socially desirable purpose, but are distinctly undesirable. In their assumption

of risks they create situations of so speculative a character that they are too hazardous to carry. Though the losses they cause do not result in the loss of any capital values of society, as do ill-advised commitments to operating enterprises, the encouragement such holding companies give to extreme speculation, with the consequent losses, tends to discourage those who commit their funds to them, unaware of the dangers of the hundred to one shot. When the bubble bursts, the explosion is disruptive of the orderly economic life of the community.

The writer has little faith in the argument of some of the promoters of utility holding companies that they are able to supply more skilled management than the small operating company can obtain for itself. It is probably true that the larger enterprise managements can supply more skills than are contained within the managements of the smaller concerns. But if there is need for such skills by the smaller concerns, a class of independent experts to supply them would probably arise — men acting in a professional capacity, as consulting engineers do. Ownership control seems hardly necessary for this purpose.

It is difficult enough for an investor to estimate the risks of an operating concern, when he has adequate figures to show the gross from operations, and the allocations to costs, until the figures available for capital are reached. An analysis of a holding company situation, with minority interests outstanding, with all the figures necessary given, is too complicated a process even for the skilful, and too laborious to be undertaken. And the opportunity that intercorporate relationships afford, of creating figures that are mystifying, seems not always to be overlooked by those in control of affairs.

SOCIALLY DESIRABLE USES OF THE HOLDING COMPANY

The fact that promoters abuse the holding company does not prove that it has no socially desirable uses. With our multiplicity of State jurisdictions, it well may be a convenient and entirely proper means for enterprise to extend itself over State boundaries. Though perhaps not a necessary device to create the large uniform financing issue, its use for that purpose may be convenient and harmless. Also the holding company is a convenient means of assembling properties that ought to be brought together for economy of operation.

Through the recent period of expansion and of creation of larger units of corporation enterprise, we have built up complicated financial structures. It is to be hoped, and it seems probable, that in our next economic period we will begin to simplify these structures.

INVESTMENT COMPANIES

What constitutes a corporation a holding company? Corporations own stock of other corporations in widely varying degrees, from a few shares to absolute ownership. Besides owning stock, sometimes they run a production or service business. Must a corporation own fifty-one per cent of the stock of another, so that the owning corporation can certainly elect the board of directors of the other, in order to be a holding company? Or do we have a holding company when a corporation owns enough stock of another to create a strong probability that the owning corporation will be able to elect the board of the other? Interesting attempts are made at terminology. But in each case the fact is the thing. Probably most people would not think of a corporation as being quite a true holding company unless owning the certain control of over fifty per cent of the stock of another corporation.

If the ownership is insufficient to afford a substantial influence in the affairs of the corporation, the stock of which is held, we certainly would not think of the situation as being that of a holding company, but would classify it as an investment corporation. Since such a company has no special significance as a corporate device, we will not enter on a discussion of it.

Enterprisers may endeavor, through use of the holding company device, to escape some aspects of the supervision of the States. A corporation chartered, say, in Delaware, may acquire control of several public utility companies operating in other States, which can regulate the operating companies, but cannot reach the holding company. This is especially the case with financing transactions.

PUBLIC UTILITY ACT OF 1935

To cover such escapes from State control as may be possible Congress has enacted the Public Utilities Act of 1935 (approved August 26, 1935). It places the usual necessary reliance of New

Deal legislation on the jurisdiction of the Federal Government over interstate commerce and the mails. At the time of writing, the act is under attack on grounds of unconstitutionality. Without hazarding here any prediction as to the outcome of this litigation, the tenor of the act will be indicated.

Under the act any corporation which holds ten per cent or more of the voting securities of a public utility company, electric or gas, is a holding company. Even an individual who has such control of a utility as to make it appropriate in the public interest to bring him under the act may be found to be a "holding company."

A holding company must register with the Federal Securities and Exchange Commission by filing a statement giving information required.

Neither a holding company nor a subsidiary may issue securities or change any rights of existing securities unless it files a "declaration" and the Commission issues an order permitting it to become effective.

Since holding company control may avoid State laws requiring the approval of State authorities for the combination of an electric company and a gas company serving substantially the same territory, the act prohibits a holding company from buying any interest in such gas and electric companies without the approval of the State authorities; and if the holding company has any interest in either, from acquiring an interest in the other without State approval. Presumably to enable anyone to remove doubt as to whether or not property is being acquired in contravention of the act, it provides that application may be made for approval of the acquisition.

Strongest opposition arises from those sections which authorize the Commission to limit a holding company to a single integrated system. The act defines an integrated system for electric utilities as "one or more units of generating plants and/or transmission lines and/or distributing facilities, whose utility assets, whether owned by one or more electric utility companies, are physically interconnected or capable of physical interconnection and which under normal conditions may be economically operated as a single interconnected and coördinated system confined in its operations to a single area or region, in one or more States, not so large as to impair (considering the state of the art and the area or region affected) the advantages of localized management,

efficient operation, and the effectiveness of regulation." Definition of a gas utility follows corresponding lines. The provisions of this section authorize the Commission to disrupt existing relationships, an unscrambling of eggs that might be difficult and costly.

The act prevents a subsidiary from extending credit to a holding company, and makes it unlawful for a holding company to extend credit to a subsidiary in contravention of rules of the Commission. It prohibits a holding company from making service, sales, or construction contracts with an associate public utility company; subjects any subsidiary to regulation of the Commission in making any such contracts with an associate company; and provides for the regulation of mutual service companies.

Registered holding companies and mutual service companies must file periodical reports, and keep such accounts and in such form as the Commission may prescribe.

Officers of holding companies must disclose to the Commission their holdings of securities of the company and its subsidiaries. They may be sued by such a company, or by a stockholder, for recovery of speculative profit unfairly made on dealing in securities of the company on inside information.

Only an outline of the more important substantive provisions of the act has been given.

CHAPTER XXIII

Equipment Trusts

One of the devices for avoiding the operation of a future acquired property clause presents such a neat adaptation of law ideas to a business situation that it merits special treatment in a consideration of corporate financing. Though the invention was daughter of the necessity for preventing the attachment to new assets of the lien of an existing mortgage, it has come to be used sometimes just to segregate one item of assets from another as security for loans: as a builder may finance the construction of one house by giving a mortgage on it, then go on and finance another house in the same way.

VARIOUS DEVICES HAVE BEEN EMPLOYED

Most of the possible means of attaining the desired results in the case of equipment have been employed; among them, the subsidiary corporation to own the cars and lease them to the user, just as for new construction by a parent corporation, which we discussed in the preceding chapter. Corporations have issued bonds with the lien of chattel mortgage on cars. Financing railroad equipments, however, has developed its special forms, which have come into general use; and in our discussion we will disregard other possible methods of setting up the transaction.

DISTINCTION BETWEEN CREDIT FOR CONSUMERS' GOODS AND CREDIT FOR THE TOOLS OF PRODUCTION

Everyone knows about the instalment plan of buying radios, automobiles, and the furniture with which the newlyweds set up housekeeping. It was conspicuous during the period of the New Era, which preceded the period of the New Deal. Enjoy while you pay. There is a distinction between financing goods in the

course of consumption by this method, and its employment in financing goods used for production — a difference between such financing of a pleasure car and a truck. One who sells a truck on credit shares in an economic risk necessarily inherent in the continuance of production.

Such credit may result in getting the management of production into the hands of incompetence, with consequential social loss. Nevertheless, it may open the door of opportunity for an individual to exercise his abilities with resultant social gain. Credit does not increase the economic ability of the individual to consume. He simply consumes now so that he may not consume in the future.

His course represents a philosophy of life, one interpretation of *carpe diem.* It is a proletarian *fruges terrarum consumere nati.* And one does not need a Malthus to point out that the people to consume the fruits of the earth are born with great frequency. Men who press the sale of consumers goods on the instalment plan sap the foundations of a sounder way of living. Such selling is one of the many defects the competitive system has developed in a greed for individual profit. This parenthetical statement is presented with apologies. It is hard, during the period of special economic maladjustment existing at the time this is written, to refrain from mention of the social problems suggested, even indirectly and remotely, by the mechanisms of corporation finance, and more interesting than our proper subject.

EQUIPMENT TRUSTS ARE FINANCING ON THE INSTALMENT PLAN

Let us return to the equipment trust. We shall see that railroads buy cars and locomotives in million dollar units by the same methods essentially as those of the instalment plan used by an individual in buying a refrigerator. Just as we have done in finding a basis in the house and lot mortgage on which to develop a consideration of corporation mortgage bond issues, let us dwell a little on the methods of the instalment plan in extending credit to the individual buyer.

CONDITIONAL SALES OF CHATTELS

The vendor sells the refrigerator on the terms of a conditional sale. That is, he delivers possession, but retains title, or legal

ownership, until the buyer completes his payments of the agreed instalments of the purchase price. The transaction is a sale subject to a condition, the condition of payment, and does not become absolute until the condition is fulfilled. When it is, the title passes to the buyer without any further act of the parties. He then becomes the unconditional owner in law. Until fulfillment of the condition, the legal property of the seller enables him to take the goods back on breach of the condition by failure to pay an instalment of the price.

EQUITIES OF THE BUYER

Just as in the case of the old Common Law mortgage, under which the land became the absolute property of the mortgagee on failure of the mortgagor to pay on the law day, so, in the case of the conditional sale, the transaction might work an injustice to the buyer unable to meet an instalment. Suppose a buyer of a $200 article, bought on terms of paying $20 a month for ten months, defaults after he has paid $160, and the seller then repossesses the article. The seller has received the $160 and has the thing back for which it was paid. All the buyer has had for his money has been eight months use.

Legislation has stepped in with a statutory remedy, which varies from State to State. In New York, for example, the seller may give the buyer notice of intention to repossess within the time the statute provides. The buyer then has that period within which to make good his default. If he does not make good, and has not theretofore paid at least half the price, the seller may keep the property as his own, without further obligation, unless the buyer serves notice of demand for resale. Or the seller may retake the article without giving notice of his intention to do so; but if he proceeds in this manner he must hold the repossessed article for a period, within which the buyer may redeem.

If the buyer demands a resale, or, in any event, if he has paid one-half or more of the price, the seller must give the buyer notice of the time and place at which the article will be sold at public auction; and, if the purchase price is $500 or more, must advertise the sale in addition to giving notice of it to the buyer. Unless the proceeds of the sale cover the expenses and the balance of the debt, the seller can hold the buyer for the deficiency; when they more than cover, the seller must pay the surplus to the buyer.

This incomplete statement of the provisions of the statute is presented just to indicate the general manner in which it protects the buyer in his equity.[1]

PROBLEM OF SALE BY THE CONDITIONAL VENDEE TO INNOCENT PURCHASER

A problem arises. What if the buyer, having possession, represents himself as the owner, and sells the article to someone who believes the representation. To be sure, the sale carries an implied warranty of title. But the crook takes his money, and departs for places unknown. When the original seller comes seeking his next instalment, he learns that his debtor has disappeared. By inquiry the creditor discovers what has become of the article, seeks out its present possessor, and demands it. Who shall prevail — the creditor or the purchaser in good faith?

Suppose A, hiring his refrigerator out to B for six months, is to get it back at the end of that time; and that B has no rights except those of possession and use for the agreed period. Then, if B, on a false representation that he is the owner, sells the article to C, when A discovers where it is, if C will not voluntarily surrender, A will succeed in an action for possession. One who has complete ownership of a chattel does not lose his ownership, except by his voluntary act, or by operation of the law, as in bankruptcy, or by levy of execution to satisfy a debt. The law protects him, even though, by voluntarily parting with possession, he put his lessee in a position in which the lessee could represent himself as owner, with such corroboration as possession affords. Society still sees its interest in making possible such partings with possessions without hazard of loss of the right of ownership.

In this case of the lease and return of the refrigerator, the man who bought from the crook had just as much ground for believing that the crook was the owner as the man who bought from the purchaser on the instalment plan. Yet society has seen fit to legislate a line between the two situations. In the instalment case the original seller has retained title for security only. All he has left in himself is the right to get the article back if the buyer fails to pay the debt. If he had collected the purchase price in full at the time of delivering possession, the transaction would have been in the clear. Society does not see the same

[1] New York Personal Property Law, Sections 76–80.

interest in protecting the seller in his security for his credit, which he might have had by keeping possession, as it sees in protecting the owner when his parting with possession is to allow the use alone.

RECORDING STATUTES

So the State provides by statute that unless the instalment seller put the fact of the conditional sale transaction on the public record, he will not be able to get the article back from one who has bought in good faith. Any buyer takes a chance, when he buys anything without a search of the public records, that he may be buying from someone who has only a conditional ownership, and may lose the article on application by the owner who has put his sale on record.

The original seller takes a chance that, even after he has put the transaction on the public record, the man to whom he sold may move out of the county, taking the article with him, and then sell. In this case, the buyer from the crook, on a search in the county office, would not find a record of the original transaction.

We have considered these rights of the innocent third party on the conditional sale situation, which especially interests us in connection with the equipment trust. The rights are, however, essentially the same if the instalment seller takes a chattel mortgage as security.

Let us see how all this applies to instalment sales of cars and locomotives; how the transaction is set up, when it includes a group of such chattels, costing in units of a million dollars; and what pieces of paper represent the obligation to pay the instalments.

TERM OF INSTALMENT SALES OF RAILROAD CARS

One problem arises immediately. The railroad which needs the equipment to use wants to spread the payments over a period of fifteen years. Though manufacturers might be glad to sell on a sixty to ninety day credit, they are not prepared to go into an instalment transaction running any such length of time as the railroad wants. So the matter becomes an investment bankers transaction, and the car companies get cash on delivery. Investors become the real instalment seller. Or, if the reader prefers,

the group of investors in the equipment trust takes the place of a finance company in ordinary individual instalment buying.

What considerations decide the duration of the instalments? The buyer wants as long a time as it can get, limited, perhaps, by some business caution. Even the buyer might not care to have the payments continue after the cars are entirely worn out and useless. Such planning to pay for dead horses, however frequent it may be in the political field of governmental finance, would certainly be unsound business. So the life of the equipment represents the maximum of possible credit.

But the creditor will not lend on such liberal terms. He insists that the buyer should have an interest in the property at the start; and that, as far as predictable losses of value are concerned, the interest at least shall not diminish. In short, the instalment must fully take care of the depreciation; indeed, as a precaution against the unpredictable risks, it is computed in an amount believed to be substantially more than sufficient to cover depreciation. While cars of wooden construction were still manufactured, a ten-year term was the standard practice for equipment trusts. With the exclusively steel construction now prevailing a fifteen-year series has become the standard practice.

CONDITIONAL SALE PLAN OF EQUIPMENT TRUST

Under the *pro forma* conditional sale plan of instalment purchase of equipment, title to the cars vests in a trustee for the benefit of holders of equipment trust bonds, issued by the railroad, and maturing in a series which represents the instalments of the purchase price of the cars. The trustee occupies the same position it does in an issue of mortgage bonds, that of the holder of the one security for the group of investors, who hold the direct obligation of the instalment buyer. The plan has the special merit of complete simplicity, and shows clearly and exactly what is done.

INFLUENCE OF A TAX SITUATION IN THE FORM OF EQUIPMENT TRUSTS

One of the tax situations which so often influence the form of transactions deflected the course of equipment trust financing. Use of this form of credit developed in Pennsylvania. Investors

of that State have long regarded it favorably, and have found justification in its excellent investment record. Philadelphia, a highly important investment center, affords a market for equipment trusts to be catered to in any way reasonably possible.

Pennsylvania adopted a classified property tax, under which it levied four mills on the dollar on securities. With a change in the form of issuance of equipment trusts, which we will consider, it was asserted by some that the kind of paper the investor held did not constitute a "security," for reasons which will appear in our description of the transaction devised. It became familiarly known as the Philadelphia plan. The writer understands that the State tax authorities did not press the matter, but, properly, obtained a change in the wording of the statute, which removed any ambiguity, and made equipment trust paper clearly taxable.

CUSTOM CONTINUES USE

Though the original reason for the deviation from the simpler set-up disappeared, the use of the variant plan had continued so long that investors had become familiar with it. Since it accomplishes everything desired, and presents no really greater difficulties than the somewhat simpler plan we have indicated, the bankers have continued its use. If they should go back to the earlier form they would have to re-educate investors.

LEASE PLAN OF EQUIPMENT TRUST

Under the Philadelphia or lease plan, the bankers cause title to the cars and locomotives to be vested in a trustee just as before. But then, instead of executing a bill of conditional sale to the railroads, the trustee executes an instrument called a lease. The railroad agrees to pay to the trustee the compensation, called rent. The lease agreement may give the railroad the option to purchase the cars for a nominal payment at the end of the term, or may simply provide that the title shall vest in the railroad after all the instalments have been paid.

As far as shaping a transaction goes, the agreement, instead of taking the form of a lease, might as well be a conditional sale, with the instalments payable to the trustee. Lawyers adopted the lease form, perchance, among other reasons, so that they might have the argument of the terminology in the event of the cars

getting into a jurisdiction in which the agreement is not recorded as a chattel mortgage or conditional sale, and being seized there by an attaching creditor. We shall have more to say later about recording statutes in connection with equipment trusts.

That the Philadelphia plan takes the form of a lease is not its essential characteristic, but that the user of the cars pays the instalments to the trustee instead of directly to the investors, as under the older device, sometimes called the New York plan, just to distinguish it. Of course these payments do not belong to the trustee. It does not lend the money which pays the manufacturer for the cars. The trustee simply acts as a central collecting agent to receive the instalments, which it then distributes to the investors, who did furnish the money.

By the terms of the trust indenture, the trustee issues certificates of participation in the trust. These certificates contain the trustee's promise to pay out pro rata to the holders of them the instalments paid by the railroad. So the total transaction involves the execution of two instruments. (1) The trust agreement provides that title to the specified cars shall vest in the trustee; that the trustee will lease the cars to the railroad under the terms of the lease annexed; that the trustee will issue certificates on which it will pay to the holders pro rata the monies received under the lease agreement. (2) The lease agreement provides that the trustee leases the cars to the railroad, and that the railroad will pay the stated number of instalments of rent of the stated amounts; and that when all instalments are paid, the railroad shall have title to the cars.

INCOME OF THE INVESTOR CALLED DIVIDENDS

Since the trustee does not make any absolute promise to pay, but only to distribute funds received, it can be seen why investors might claim that the certificates of the trustee are not "securities" in a strict sense; and with the principle (often honored in the breach) that tax statutes are to be construed in favor of the taxpayer, why investors might further claim that they were not subject to taxation on their certificates. Language of the Street correctly preserves the distinction of form, however, in calling the distributions to the investor "dividends" instead of interest. When the real estate people began to use the certificate of participation form to finance apartment houses and office buildings,

they did it more crudely than the corporation people in the equipment trust situation, and called the distributions "interest."

ENDORSEMENT OF RAILROAD'S GUARANTEE OF PAYMENT

A word needs to be added to complete this sketch. If the transaction were left at this point, only the trustee could sue the railroad for breach of its agreement. So far, the obligation of the user of the cars runs only to the trustee, not at all to the investor. To give the certificate holder a direct right against the railroad, it endorses on the certificates a guarantee that it will fulfil its obligations under the lease. In actual practice the individual certificate holder will not sue, but will join with his fellows in requiring the trustee to take such action as may be necessary for their protection. However, the guarantee presents a precaution against a recalcitrant trustee.

TITLE MUST BE KEPT OUT OF THE RAILROAD

Now that we have outlined the equipment trust, let us examine it more in detail. We dwell on it a little because it presents so good an example of corporation finance dealing with investor's risks. To avoid all question of the operation of future acquired property clauses, or other possible attaching claims, great care must be taken to see that the user on the instalment plan gets no color of title. Those in charge of the transaction shape it carefully to this end.

CONTRACT FOR MANUFACTURER

After the management of the railroad has come to at least a general understanding with its bankers that they will purchase an issue of equipment trust certificates sufficient to meet the requirements of the carrier, the representatives of the railroad place its orders with the car manufacturing companies. The contract specifies the cars in detail, states the place of delivery, and provides for payment of cash on delivery. If carefully drawn, the agreement stipulates that the right to receive the cars may be assigned, but that the carrier will remain liable for payment. On this contract the car companies start production.

FUNCTION OF THE "VENDOR"

The manufacturer, however, must not make delivery of a single car to the carrier. To do so would pass title to the railroad; or if the contract had been so drawn as to prevent this result, the delivery would be evidence to overcome, and would create that much difficulty in establishing that title had not passed. The contract must be assigned to someone who will step into the shoes of the railroad as the buyer of the cars. Though, as far as legal form goes, the trustee might become the buyer, it will not undertake any liability to pay unless it has been furnished with cash in hand sufficient to pay the full amount of the obligation under the contract; and no one is ready yet to put up this sum of cash.

So a formal intermediary is provided; and may be an individual or individuals, or may be a corporation organized for the purpose; let us assume a corporation. It serves simply as a conduit pipe to take title from the manufacturer and vest it in the trustee. From this function of transferring title to the trustee it is called the "vendor." It might as appropriately be called the vendee. But it enters into the trust agreement with the trustee, and in that agreement is not in the position of buyer but of seller only. The manufacturers consent to deliver the cars to this assignee of their contract.

DESIGNATION OF AGENTS FOR DELIVERY

While the manufacturers are carrying on construction of the cars, arrangements are made to establish the evidence that title vests ultimately in the trustee and that the railroad gets no color of title. The contract states the place for delivery of the cars. It is likely to be where the car company shops are located. The intermediary designates an agent to take delivery of the cars from the manufacturer as it completes construction; the trustee, an agent to take delivery from the intermediary "vendor"; the carrier lessee, an agent to take delivery from the trustee. All these designations are in writing and, with written acceptances of the appointments, will be filed with the trustee as part of the records of the trust. With the other necessary documents, the nature of which will appear as we go on with the transaction, these trust records run to a substantial file.

PROVISION FOR "PLATING"

When we were discussing the ordinary instalment sale, we saw that if the contract were not recorded in the county where the article is located, a purchaser in good faith would prevail against the seller who holds title for purpose of security. Railroad cars, however, do not stay in one county. To move about is their very nature. The people interested in the issuance of car trust securities have procured the adoption in every State, or in nearly all, of a statute providing that recording of an equipment trust agreement at one point, usually in the office of the Secretary of State, shall be sufficient to protect the creditor throughout the State.

If the lines of the railroad buying the equipment on the instalment plan run through several States, the agreement will be recorded in each State in which the rails run. In the business of transportation, as it has developed, however, cars do not stay all the time on the lines of the instalment buyer. With a full car shipment, the car will run from the point of the consignor to the point of the consignee; it may pass over several lines and through various States in which the agreement is not recorded. The special recording statutes require that each car of the trust be plainly marked with a metal plate, indicating that it is the property of the trustee under an equipment trust.

Even if the statutes did not require this "plating" it would be done. With a car conspicuously carrying this proclamation of ownership it would be difficult for anyone to be oblivious of it. At least it is relied on to protect the security when the car is out of a State in which the agreement is recorded. Besides, no substantial part of the trust assets would be open to attack.

EQUITY IN EQUIPMENT

Investors selling equipment on the instalment plan to railroads, through bankers and the device of the trustee, require a down payment just as any other instalment seller. In practice the down payment has usually been twenty-five per cent of the cost, plus any discount at which the certificates may be bought by the bankers. That is, the equipment costs $33\frac{1}{3}$ per cent more than the face amount of certificates issued against it. The carrier must be able to provide this equity in cash. And it is a down

payment in the same sense as the first payment on any instalment sale. Later we will see the process of payment.

PREPARING TRUST INDENTURE AND LEASE

While the manufacturers are in the course of constructing their first batches of cars, counsel for the bankers are working on the trust indenture and the lease, which together carry out the plan. Contracts with the manufacturers call for the delivery of a certain number of cars of very definite specifications, and assign to each of the cars the serial number which the carrier wants on it.

The trust agreement states the serial number of every car to be put in the trust, with a brief description of its tonnage and type. It contains the provisions for insurance, and for the replacement of cars which may be destroyed. It presents the conditions under which the trustee may issue its certificates of participation, and contains the other covenants desirable for the protection of investors. Some of these matters will appear as we further discuss the transaction.

Face amount of the certificates authorized, which mature serially, represent an equal annual (or semi-annual) instalment of principal. They call for a dividend distribution at the agreed rate. We have already considered in the chapter on amortization the principles which require the certificates to mature serially. Of course, the trustee, issuing the certificates, promises to pay only, when, as, and if received, the amounts payable to it by the railroad under the terms of the lease.

The lease provides that the carrier shall have the possession and use of the equipment on paying the stipulated instalments. We repeat that their amount is calculated on the basis of the equal annual instalment of principal plus the sum necessary to pay the agreed income on the certificates outstanding.

DELIVERY OF CARS

Each railroad car, even an ordinary freight car, to say nothing of specialized types of tank car, refrigerator car, all the way to the most expensive passenger car, is quite a piece of property, and takes time to fabricate. Construction and delivery of such a number as a railroad orders may well run over a period of nearly a year. Much of this time will elapse before the car com-

pany has completed the first cars for delivery. It is likely to deliver them in lots of five, ten, or fifteen. The car company must not deliver one car until the trust is completely set up — the instruments of trust executed and delivered, the agents for delivery of the cars designated and ready to act. For the cars must come into the trust immediately on the manufacturer's parting with title.

BILLS OF SALE AND CERTIFICATES OF DELIVERY

When the car company completes each lot of cars, it executes a bill of sale, which it delivers to the agent of the intermediary, called the vendor, as we have seen. Each of the several agents for delivery — of the vendor, the trustee, the lessee — inspects the cars to see that they are in accordance with the specifications and have the proper numbers; then each agent makes a certificate that he has received delivery; the agent of the vendor, from the car company; the agent of the trustee, from the vendor; the agent of the lessee, from the trustee. When the agent for the trustee makes out his certificate, he adds the fact that the car is properly plated to show the ownership of the trustee.

At the same time the vendor executes and delivers a bill of sale to the trustee. In due course, the vendor furnishes the trustee with originals of the certificates of delivery, and a certified copy of the car company's bill of sale to it. When the car company delivers its bill of sale to the vendor, it also furnishes a certificate of its counsel that the cars are free from all liens, or adverse claims, and that the bill of sale makes good title. Counsel for the vendor furnishes the trustee with a corresponding certificate based on the certificate of clear title to it.

PAYMENT FOR CARS

Bankers have the frequent problem of getting delivery of an entire issue so that they may proceed with and finish their job of selling. It is solved in the usual way of turning cash over to the trustee for it to pay out as the tangible assets are created and delivered. We will discuss the process of closing, that is, of the bankers paying the purchase price and taking the security, when we come to consider the work of the investment houses. Let us assume here that the closing takes place before any cars are de-

livered. If, after the trust was constituted, the manufacturer completed and delivered any cars, the railroad would pay for them on behalf of the vendor, and receive credit for so much of the down payment.

Since we are assuming that no cars have been delivered, the railroad lessee will, at the closing, pay to the trustee all of the down payment; and the bankers will, on the order of the vendor, pay to the trustee the agreed purchase price for the certificates. On receiving these monies, the trustee, in accordance with the authorization of the trust indenture, delivers its certificates of participation in the car trust. It has been indicated already that the amount of the down payment, which the lessee must make, is sufficient to take up any discount at which the bankers buy the certificates. If the financing agreement of the bankers with the railroad provides that the certificates may be issued up to seventy-five per cent of the cost of the equipment, and the bankers are buying the certificates at 95, the lessee will actually have to provide thirty per cent of the cost.

TRUSTEE'S PAYMENT OUT OF CASH

By the trust indenture the trustee is authorized to pay out to the car companies the contract price for each car as it is delivered. It may take many months after the closing before all the cars are manufactured. But the bankers have the certificates, which they can sell to reimburse the cash paid on taking delivery.

SECURITY OF EQUIPMENT TRUST CERTIFICATES

We will not delay to discuss possible equities of the carrier in the equipment to be cut off on default after it has paid a substantial part of the purchase price. Such equities, in any case, would not be any stronger under the lease plan than under the conditional sale plan. We will consider the matter of liquidating contract rights when we come to the subject of reorganizations.

Since the carrier does not have title to the equipment, a receiver cannot permanently retain it for his use in operating the road without paying the instalments as they become due. He has his election to affirm or disaffirm the contract, but with a reasonable time to decide. After such time the owner (trustee) can put him to his election by demanding repossession of the cars. The

receiver, however, must pay the reasonable value of their use during the period that he retains them.

Equipment trust securities have enjoyed a good investment record. Even in the times of reduced business, when corporations run into financial difficulties, usually the receiver has found that he could not operate the road advantageously if it should lose all the cars under a trust. Since use of the equipment is necessary to keep the going concern values, the receiver has obtained authority from the court to adopt the lease agreement.

Equipment trust financing presents a neat fitting of business requirements and law concepts. It meets the exigencies of the future acquired property clause. It deals with the peculiar difficulties of an ambulatory chattel in addition to all the other difficulties of chattel security. By the trust agreement for handling cash it provides clearance financing and gives the investment banker an issue to market. Through the serial maturity it disposes of the problem of a depreciating asset.

Fifth Section

Changes in Membership of Shareholder and Creditor Groups

It is hardly needful to say that payment of the fees and taxes statutorily required on organization is a condition precedent to acceptance of the instrument presented for filing. It is "recorded," i.e., entered in the official record, in the office of the Secretary of State; or it may be only filed there, and recorded in the county in which the principal office of the corporation is located.

Often, following the language used when each corporation was a special grant from the sovereign authority, the instrument filed is called the charter, and it may be so designated in a statute. No attempt is made here to present the process of incorporation in detail. Such presentation could be made only for a particular State. Only enough is said here to indicate that certain individuals sign and acknowledge an instrument to initiate the incorporating process. These individuals are the "incorporators." It is commonly the case that they agree to take an indicated number of shares of stock, and the statute may require a minimum number of shares to be so indicated. So they are subscribers to the capital stock.

Incorporators must meet the statutory requirements for qualification. In one State, for example, they must be "three or more natural persons, who must be of full age, at least two-thirds of whom must be citizens of the United States, and at least one of them a resident of the State." The phrase "natural persons" excludes a corporation from being an incorporator.

Such incorporators constitute a group which, at some definite point in the line of proceedings, as on the filing of the certificate of incorporation, becomes a corporation. It is possible that the "group" initially formulating may include other people. They have joined in agreeing to take stock in the proposed corporation; and by agreement they are bound to each other, and will become bound to the corporation after it comes into being.

We will pause a moment in our discussion of the corporate group to comment again on the distinction between the individuals who, as individuals, compose the group, and these individuals in their corporate aspect which came to be seen and spoken of as constituting a corporate "person." Before the instant of incorporation there may be a group, but it is not a body corporate. Until then they do not have the right to act in the manner in which they may act as a corporation. And they do not have the relationships to each other, and to people not members of the

group, which the corporation statutes, and the non-statutory law, confer or impose on them.

On the instant of incorporation the incorporators become such a group, capable of the admission of other members, but others are not members until admitted. So, if the incorporators were, before incorporation, only part of a group agreeing to take stock, the others, by acceptance of the charter, become members of the corporate group, and subscribers to the stock. Before the acceptance, they are bound to each other, subject to all the ways in which individuals not in a corporate relationship may enforce rights; but they are obliged to proceed in a non-corporate way in the enforcement of their rights.

With this word, we will disregard any pre-corporate group other than that of the incorporators, who become the corporate group on the instant of incorporation. Ordinarily the incorporators are few in number, only the minimum required, say, three people. Also, ordinarily they agree in the certificate or articles they file to take only the minimum number of shares the statute requires to be so subscribed. The statute may require that greater minimum amount of stock be subscribed before the corporation may "begin business."

Even if that is not the case, the amount of stock subscribed by the incorporators would seldom be as much as was contemplated for beginning business. If the incorporators are people really interested in the promotion of the proposed corporate enterprise, not "dummies" acting at the instance of the real parties in interest, and merely constituting a "group," they themselves are likely to be intending a larger capital contribution than they have subscribed in the certificate of incorporation.

OPENING THE BOOKS FOR SUBSCRIPTIONS

On organization of the corporation, books may be opened for subscription to the capital stock. If the promoters contemplate only a small beginning group to consist of people already known, they have probably actually agreed, or informally understood, just how much each will subscribe; and taking the subscription marks their entry into the corporate group of stockholders. Opening of the books to those who intend to subscribe presents the form of an offer from the corporation, and the subscription is an acceptance completing the agreement. The consideration

is the promise, actual or implied, of the subscriber to pay the amount subscribed, and the promise of the corporation to admit the subscriber to an interest in its enterprise, and issue a stock certificate as evidence thereof.

SUBSCRIPTION SUBJECT TO ALLOTMENT

But if the promoters propose an invitation to the public at large, or to any considerable number of people, presumably the corporation will open its books for the subscription "subject to allotment." In this form the opening of the books is not an offer, but an invitation. The subscription is then the offer to become a stockholder; the allotment is the acceptance of the offer, and notification to the subscriber. If the offer is to subscribe to all or any part of the indicated number of shares, as it ordinarily would be under the terms of the invitation, the allotment, of course, may be of a smaller number of shares than the full amount of the offer. The offerer becomes a "subscriber," and a member of the corporate group on the allotment.

SUBSCRIBER OR PURCHASER

In a strict sense, only those who enter the group through this initial agreement, whether pre-corporate or at the time of organization, are "subscribers." One who, at a later time, agrees to take stock, is a "purchaser" rather than a subscriber. Ordinary language of the Street preserves no such distinction.

In law there is a distinction, at least in that on a subscription the corporation may sue a "subscriber" for the amount subscribed without first tendering a certificate, but may sue a "purchaser" only after such tender. If we may generalize, it would seem that after incorporation a "subscriber" becomes a member of the corporate group, a stockholder, at the moment of making the agreement; but that a purchaser does not become a member of the group until he has performed, in accordance with the agreement, by paying the purchase price, or, in the case of stock not immediately to be full paid, on making the payment initially required. Very likely no useful purpose is served by this distinction. It is mentioned here only to show one line serving to divide those who are shareholders from those who are not.

MOMENT OF MEMBERSHIP DETERMINATIVE OF RIGHTS

Just when one becomes a member of the stockholder group is important. If a man is a member, he is entitled to notices of all stockholder meetings, at least of those at which he would have a right to vote; and the meeting is not validly constituted unless the notice has been given, or the right to it waived by the stockholder. Whether or not a man is a stockholder determines his right to vote (unless by the terms of the stockholder contract expressed in the certificate of incorporation the right has been cut off); it determines his right to share in a distribution of profits; it determines his preëmptive right to subscribe to an additional issuance of stock. It seems doubtful if the distribution between subscription and purchase has a value that is worth preserving, but the condition of the law as it stands requires us to recognize its existence.

MEMBERSHIP BY TRANSFER OF RIGHTS

The third way in which one may become a member of the group is by transfer. In this method the new member, by contract, acquired, from or through a stockholder, a right to be or become one of the group. He may, in most instances does, purchase the right; the purchase, however, is not from the corporation, but from a stockholder, or from one who has a right to become a stockholder.

THE GROUP CHANGING

So we have a group capable of expanding and of contracting. We have the little group of incorporators expanding through subscription or purchase (from the corporation), and through transfer from a stockholder of a right to enter. Obviously, if the entire right of an existing stockholder, all of his stock, is transferred, the membership does not expand, though its persons change. But if part of the stock of an existing stockholder is transferred to one not already a stockholder, the existing stockholder continues and an additional member is admitted. The group contracts through the transfer to an existing stockholder (or to the corporation acquiring treasury stock) of all of the shares of a stockholder. Under a statutory provision requiring at least

three incorporators, there must be a group to incorporate; yet this group may, by process of transfer, contract until there is no actual group, but only a single stockholder. He, however, has the potentiality of again creating an actual group by the transfer of part of his shares. If the jurisdiction of incorporation requires directors to be stockholders, obviously this contraction to a single stockholder is not possible.

SINGLE STOCKHOLDER CORPORATIONS

Such a single stockholder corporation is an incidental and unintentional outcome of the corporation idea of a social mechanism for group action. The possibility is taken advantage of by individuals desiring to conduct a business in the corporate form. Usually they incorporate for the sake of limited liability, but sometimes in anticipation of death, to provide in a simple way for a continuation of a business through a distribution of stock instead of liquidation or sale of the enterprise.

Doubtless such a limitation of liability has been looked upon as a shameful thing by many people who believe that an individual showed good faith only by full responsibility for his acts. And there is much to be said for this viewpoint of integrity. On the other hand, if people know the limitation, and nevertheless are willing to contract, a corporation formed for the sake of this advantage seems not a social injury on the contractual side.

Torts are another matter. Here there is no consent of the injured party to the limitation of liability. There have been instances of one corporation controlled by another in which the fiction of the corporate personality has been swept aside; and the controlling corporation held liable as a principal is liable for the acts of an agent. Nevertheless, probably individuals sometimes incorporate their enterprises with the primary idea of limiting loss on account of tort liabilities.

STOCKHOLDER RECORDS

Statutes require a corporation to keep a stock ledger at its principal (or official) office, which must be in the State of incorporation, and provide for its availability for inspection by stockholders. A stockholder has a right to be able to find out who are his fellow members in the group so that he may communicate with them on the affairs of the corporation. Stockholders' exam-

ination of the stock ledger has been much abused in order to obtain lists for solicitation on other than corporate matters. Officers may refuse access on the ground that it is not for a proper purpose, and put the applicant to court action to compel it.

Such terms as "stock ledger," "opening the stock books for subscription," etc., do not mean that a literal "book" must be kept. Any appropriate method of record keeping presumably serves the purpose.

Of course, even in the absence of statutory requirement, a corporation would have to keep a stockholder record as a practical matter in the conduct of its affairs; but it would not necessarily keep it in the jurisdiction of incorporation. Often the enterprise conducts none of its ordinary business at its official statutory office; so, keeping any part of its records there is an inconvenience, but an entirely proper one. In such cases, the records made at the office or offices where the corporation actually issues and transfers its stock are prepared in duplicate, and one copy is transmitted to the statutory office.

MAKING UP THE STOCK LIST

For various purposes, at various times, the secretary (or other officer) having charge of the stockholder records must make up the stock list. It must be made up for the purpose of sending notices of stockholder meetings, and for any other communication of the directors with the stockholder group. Since, presumably, the books are not closed for transfers on sending out a notice of meeting, the list must again be made up to determine who are entitled to vote.

A resolution declaring a dividend states that it will be payable to stockholders of record on a certain date, and again the list must be made up. It must be made correspondingly on a resolution for the issuance of additional stock, creating stockholders' rights. As already suggested, the stock books may be closed, so that transfers cannot be made for a brief period, in order to give time for making up the list. In actual operation, in the case of active market stocks, the lists are kept up to date. There is no actual closure, unless for a brief period over an annual or other meeting of stockholders, so that new members may not claim entry into the group, causing confusion in the orderly process of the meeting.

STOCK CERTIFICATES

Issuance of a stock certificate merely gives possession of evidence of being a stockholder with an interest in the corporation to the extent indicated; and it affords a convenient machinery for the transference of that interest, or a fungible part of it. A statement on the face of the certificate of the name of the corporation, the State of incorporation, the name of the stockholder, and the number of shares of the class of stock represented, would be sufficient to serve the purpose.

Generally the statutes make additional requirements, such as a statement of the authorized capital. And they go so far, in the case of more than one class of stock authorized, as to require the full stockholder contract provisions of the certificate of incorporation to be printed on the face, or on the back, of the certificate. For convenience in tracing and identifying the transaction, the certificate carries a serial number and the date of issuance. The statutes usually indicate the officers required to sign.

The certificate presents adequate evidence of membership in the stockholder group, and of the amount of interest in the enterprise. Since a stockholder can cause the admission of new members up to a number equal to the number of shares he holds, the certificate affords a convenient part of the mechanism for such admissions. Turn to the back of the certificate and consider the form of power of attorney printed there.

STOCK POWER

This power of attorney reads substantially as follows:

For value received ____ hereby sell, assign and transfer unto ____ shares of the Capital Stock represented by the within certificate, and do hereby irrevocably constitute and appoint ____ attorney to transfer the said stock on the books of the within named Company, with full power of substitution in the premises.

Dated ________, 19

In Presence of____.

____

Such an instrument, commonly spoken of as a stock power, would, if fully designated, be called an assignment and power of attorney. That is, a stockholder has a right to cause the ad-

mission of new members; and he may assign this right. But, for the functioning of the corporate mechanism, a person so introduced for membership must be enrolled, and the extent of his share interest entered on the corporate records. In the contemplation of the law, the stockholder or his agent goes to the office of the corporation and himself makes the entry on the records of the transfer of all or part of his interest.

CONSENT TO BE A STOCKHOLDER, OR TO TAKE AN ADDITIONAL INTEREST

But does such an entry establish the intent of the other person, named as the transferee, to become a stockholder? A man cannot be a stockholder against his will. Suppose Jones, a stockholder, goes to the corporation and transfers ten shares of stock into the name of Brown, who knows nothing about what Jones is doing. Brown is not a stockholder, unless he was so previously; and if he was previously a stockholder, he does not really own the additional interest. If he subsequently accepts a certificate from Jones, or accepts dividends from the corporation on the shares which Jones has transferred on the records, Brown becomes a stockholder, or an owner of the additional interest. Or, if Brown was not formerly a member of the group, and now attends corporate meetings, taking part in them, he indicates his consent to be a stockholder.

OPERATION OF POWER TO TRANSFER

Actually Jones does not make a trip to the office of the corporation to transfer his stock. Aside from the inconvenience to him of personally making the transfer, the management of the corporation does not want him interrupting the orderly course of its affairs, and messing up its books with his handwriting. Jones does not have to make the entries with his own physical hand. Our law recognizes that a man may act by an agent; that acts done by the agent for his principal are as if done by the principal himself. Jones can designate someone to make the necessary entries for him. He does so by executing the assignment and power of attorney. In the language of the Street he "endorses" the certificate, merely indicating that he writes on the back.

TRANSFER OF ALL SHARES REPRESENTED BY CERTIFICATE

"For value received I, John Jones, hereby sell, assign," etc. He can go on, if he wants to, with "transfer unto James Brown." We will assume that he does so, and puts the word "ten (10)" immediately after the name and before the word "shares." For the further purposes of our illustration we will assume that the face of the certificate shows that Jones is the owner of ten shares.

Jones comes to the blank after the word "appoint" and before the word "attorney." If he wants to, he can fill in the name "James Brown" here, or the name of any other person he desires. But if he does fill in the name of anyone, that person will have to act, or in turn designate someone else to act. Omitting to fill in this blank, Jones impliedly authorizes the one to whom he assigns the stock, and delivers the certificate and assignment, to fill the blank or cause it to be filled.

In actual practice no one will fill this blank until the certificate is presented to the corporation. Then the person presenting the certificate will request the transfer and leave the certificate, taking a receipt for it. In the orderly course of business the agent of the corporation will then enter in the blank the name of the person to make the entries in the corporate records. A new certificate will be prepared in the name of Brown, and delivered to the person who presents the receipt for the original certificate.

TRANSFER OF PART OF SHARES REPRESENTED BY CERTIFICATE

If, as we have assumed, Jones is selling all the shares represented by the certificate, he can simply sign the power and deliver the certificate to Brown on receiving the purchase price. Let us now assume that the certificate evidences the ownership of twenty shares, and that Jones, as before, is selling ten shares to Brown. Jones will not, in this instance, want to deliver his certificate to Brown, even after filling in the assignment blank with "transfer unto John Jones ten shares and to James Brown ten shares."

On that authorization the corporate entry would have to be made showing Jones still a stockholder to the extent of ten shares, but Brown, having possession of the original certificate, and surrendering it to the corporation, would be in a position to get

both the new certificates. Jones, to be sure, would be entered on the books of the corporation as owning the ten shares not transferred to Brown, and would receive the dividends. But he cannot sell his stock, because the corporation will not transfer it (except as will be noted later) unless the certificate representing it is surrendered.

Jones wants to protect himself completely until he gets paid for the ten shares he is selling; and Brown will not pay until he is made a stockholder owning ten shares or given a power, which no one can prevent his exercising, for acquiring a stock interest of that extent. Both these purposes can be effectively accomplished only by Jones taking or sending his certificate to the corporation, and getting it "split" into two certificates for ten shares each in his own name. He can then sign the power on one and deliver it to Brown on receipt of payment.

Jones cannot safely have the corporation issue one certificate in his own name for ten shares, and one in the name of Brown for ten; for then, if Brown should not pay, Jones would be in an embarrassing position. He has caused Brown to be entered in the corporate records as the owner of the shares; and as far as the corporation is concerned, Brown is the owner. It does not take cognizance of the fact that Brown has not paid Jones. It might be that Jones intended a gift to Brown. And how is the corporation to know whether Brown has paid or not? It will not transfer the ten shares back into the name of Jones without the consent of Brown, expressed by his signature to the power.

"FULL POWER OF SUBSTITUTION"

Assume that inadvertently or otherwise Jones does fill a name in the blank before the word "attorney." Then, as has been said, the stock cannot be transferred without action by the person so named. It is still, however, not necessary that this particular person make the entries in the corporate records. There is the saving clause "with full power of substitution in the premises." Except for this clause the legal principle that an agent, unless authorized by his principal, cannot delegate his authority to another might be invoked. Its invocation is guarded against by this clause.

If the principal expressly authorizes the agent to sub-delegate his authority, of course the agent may do so. Then, on the

entry of a name in this blank, the person indicated could attach his additional power: "I irrevocably constitute and appoint ——— my attorney to transfer the within named stock, under the foregoing power of attorney, with like full power of substitution in the premises."

Generally the appointment of an agent is revocable at the will of the principal. If the person appointed, however, has an interest in the transaction the agency is irrevocable. Here, presumably, the person to whom the certificate is delivered with the blank which he has authority to fill in has, by his purchase, such an interest that the authorization is irrevocable.

EVIDENCE OF GENUINENESS OF SIGNATURE

How does the corporation know that the signature subscribed to the power of attorney is the signature of the stockholder and not a forgery? Of course, if the stockholder is one of the original subscribers to the stock, the corporation has his signature with which it can compare. But, in the ordinary course, it is, on transfers, constantly issuing certificates to new stockholders, whose signatures its transfer agents do not in the least know.

Yet it may transfer stock only on proper authority. A transfer made by virtue of a forged signature on a power is no transfer. The stockholder whose name was forged still owns the stock. But the corporation has issued a new certificate representing that the person whose name appears in its face is a stockholder for the number of shares named. If he is in good faith, in no way a party to the fraud, and has paid his money for the stock in ignorance of the fraud, he can hold the corporation liable. It must make him whole by recognizing him as a stockholder, if it has authorized and unissued stock which it can issue; or by compensating him in damages.

The situation lays a heavy responsibility on the corporate agents to make no transfers which are not authorized. The signature to the power must be genuine, and must carry an authority existing at the time of the transfer. The second clause of the preceding sentence is inserted to cover a situation like this: assume that a stockholder signs the power without selling the stock or giving it away, retaining the certificate among his securities, and then dies. No one has acquired an interest in the stock to make the authority irrevocable. On the facts indicated

no one has been given any authority. We will consider this situation later in connection with transfers of stock of deceased stockholders. For the moment we will stick to the problem of assurance of the genuineness of signature.

Corporate agents require adequate evidence of genuineness. Usually this takes the form of a guarantee by the stock exchange firm which is acting as broker in the transfer, or the corresponding guarantee by a bank known to the agents of the corporation. Question arises whether a bank has any corporate authority to give such guarantees, and therefore whether they establish any liability, and have value beyond the actual fact of identification. For the active New York market the transfer agencies procure and keep on file the signatures of those who are authorized to sign for the stock exchange firms and the banks.

A notary's certification of acknowledgment of execution by the transferor proves the signature. In view of the rather common looseness of identification by notaries, the transfer agencies prefer a stock exchange firm or bank guarantee to a notarial acknowledgment. For transactions carried through on the stock exchanges, the acting brokers attend to these matters of transfer. This service is part of the very considerable labor they perform in the course of earning their commissions, which their customers seldom appreciate.

ENDORSEMENT IN BLANK

Signing the power of attorney on the back of a stock certificate is commonly spoken of as an "endorsement." Of course the word "endorsement" as used here does not have certain special significances it has when used in connection with negotiable instruments. If the blank for the name of the transferee is not filled, the certificate is spoken of as "endorsed in blank," a phrase also used in reference to negotiable instruments. Such a stock power enables the certificate to be passed from hand to hand, as evidence of a right to become a stockholder, without any actual transfer on the books of the corporation. In that condition the certificate is said to be a "street delivery." Possible consequences of putting the certificate in that form will be discussed later.

STOCK TRANSFER STAMP TAXES

Federal and State governments, reaching out for additional sources of revenue, have imposed an expense and additional labor

on the transfer of stock through their impositions of stamp taxes. For purposes of illustration, New York, which has the great market of the New York Stock Exchange and the Curb Exchange, is chosen to represent the requirements of a State government. Federal and (where enacted) State statutes require the affixation and cancellation of special revenue stamps. These stamps are placed on the stock certificates or, in the case of transfer of the right to become a stockholder by delivery of a certificate endorsed in blank, on a memorandum of sale delivered to the purchaser.

Revenue Act of 1926 as amended by the act of 1932 made the rates for the Federal Government four cents on each $100 of par value stock, or on each no par value share; if, in either case, the selling price be $20 or more a share the tax is five cents. The statute provided, however, that after July 1, 1935, the rate should revert to the former two cents for each $100 of par value, or each no par value share, irrespective of sales price.

For New York State the tax is three cents on each share sold for less than $20 a share, and four cents for each share sold for $20 or more. The statute provides that after June 30, 1938, the rate shall be one-half of these amounts (i.e., one-half is an "emergency" tax).

It will be noted that New York does not now make any reference to par values, but bases the tax exclusively on selling price. This method avoids the stock transfer disadvantage of no par value shares issued for an actual consideration of, say, $5 a share, as against shares of a par value of $5, by which twenty of the par value shares carry no more tax burden than one of the no par shares.

Though these rates will vary from time to time as the exigencies of the governments vary, or as the traffic will bear, or as vociferous complaint becomes effective, this method of exacting revenue has been adopted, and is not likely to be abandoned. And the procedure is likely to continue substantially the same. The burden is not light. The rates given above are presented merely to indicate the general nature of the burden. For any action the statutes should be carefully checked to date.

Under the New York statute the seller has the duty of affixing and canceling the stamps. The statute makes it a penal offense of the seller to fail in his duty, and of the corporation to transfer without the stamps. And the method of canceling the stamps is elaborately prescribed. For New York, the provisions of the tax

department rule require that the person using or affixing them write or stamp on them the initials of his name, and the date on which they are attached or used, and to cut or perforate them in a substantial manner, so that they cannot be used again. A failure to comply is a "misdemeanor."

Regulations under the Federal statute are even more elaborate. "The person using or affixing the stamp shall write or stamp thereon, in ink, his initials and the day, month, and year on which the same shall be affixed, or shall, by cutting or cancelling with a machine or punch, affix his initials and the date as aforesaid, and so deface such stamp as to render it unfit for re-use. In addition to the foregoing, stamps of the value of 50 cents or more shall have three parallel incisions made with some sharp instrument lengthwise through the stamp after the same has been attached to the certificate, instrument, or bill, or memorandum, or other evidence of sale or transfer; but this shall not be required where stamps are cancelled by perforation. The cancellation by either method shall not so deface the stamp as to prevent its denomination and genuineness from being readily determined."

Provisions of the Federal statute do not impose the burdens of the tax on the seller, but make both parties to the transaction responsible for payment. Failure to affix the stamps is a Federal penal offense. The parties may agree as to who shall pay the tax. In practice the seller pays for and affixes the stamps; and if no agreement is made it would seem that this general practice would govern, as implied in the agreement of sale. The Federal statute does not attempt jurisdiction over the corporation making the transfer.

DETACHED POWERS

Sometimes, for convenience or safety, the form of assignment and power of attorney on the back of the certificate is not utilized, but a separate instrument is resorted to. Except that such a separate instrument needs to contain statements identifying the stock certificate to which it refers, it is in the same form as that on the back of the certificate. If a stock certificate is in the custody of someone other than the person in whose name it stands, the use of a detached power may save inconvenience and danger in transmitting the certificate to the inscribed stockholder for his signature.

Since the stock certificate is not endorsed, and the signature

sought is necessary for transfer, no thief or finder, as we shall see, could deprive the proper persons of their rights until that signature is affixed. Nevertheless, theft or loss would cause the rightful owner expense and great inconvenience. If an endorsement in blank is desired, theft or loss on the return trip might result in an actual loss to the owner of his rights.

A stockholder who has his certificate, and wishes to transmit it, with power to transfer, can safeguard the transmittal by sending the certificate unendorsed in one envelope, and a detached power in another envelope. Further, if the name of a transferee has been filled in on the endorsed form of power, nevertheless, by using a detached power, ownership can be transferred without a transfer on the books of the corporation and the issuance of a new certificate.

NATURE OF STOCK CERTIFICATE AND ITS CONSEQUENCES

Though a stock certificate is not a negotiable instrument, the operation of the legal principle of estoppel works out many of the consequences of negotiability. Suppose an owner of stock signs the power on the back, leaving the space for the name of a transferee blank, and loses the certificate, or carelessly leaves it where it can be stolen. A finder or a thief can represent himself as the owner. For purposes of business convenience it is customary to deliver certificates endorsed in blank. A buyer of stock has no reason to suspect anything out of the way merely because such a certificate is offered to him as a delivery on the sale.

Ought the man who lost the certificate, or had it stolen from him, have the stock; or the man who paid value for it in good faith? It is a general principle of law that a finder or a thief does not get title to property, and, except in the case of negotiable instruments, that no purchaser from a finder or thief can get title. But in the case of the stock certificate the owner could have protected himself by not signing the power. After signing the power he could have been more careful and not lost the certificate, or might perhaps have protected it better against theft.

A purchaser from one who has found or stolen the certificate could, to be sure, as in the case of tangible property, trace the chain of title. In the case of tangible property he purchases at

his risk as to ownership. But the tangible property situation affords an owner no easy way of protecting himself; as he can, by not putting an endorsement on a stock certificate. A social interest in the marketability of corporate stock has developed, and is persuasive to conclusions which aid easy transference.

Still, in the absence of statute, the law has generally required some element of negligence, beyond an endorsement of the certificate, to deprive the owner of his property. If he kept the certificate endorsed in blank in a good safe, to which, nevertheless, burglars gained entry, probably the law would preserve his right of property. But if any element of negligence beyond the endorsement exists, the owner would be said to be estopped from asserting his claim, and the purchaser in good faith be protected as now the owner. In the next chapter we shall see the effect of the Uniform Stock Transfer Act.

CREDITORS OF THE INDIVIDUAL STOCKHOLDER

Other questions, however, arise on the problem of the ownership of stock. Of course the words "owner" and "ownership" are simply symbols to indicate a series of rights and responsibilities, or relationships of people to each other. Such relationships may be with respect to tangible things. In a corporate enterprise the relationship of any one stockholder to the tangible things used in the enterprise is attenuated to a vanishing point through the relationship of the entire existent or potential corporate group to the things. As far as the condition of being a stockholder is concerned, we regard it essentially only a relationship of people to each other. But in these relationships we have various people and groups of people.

So far in this chapter we have discussed only the relationship of the stockholder to one who would claim to be his successor in his rights. In earlier chapters we have considered his relationships to his fellow members of the stockholder group and to creditors of the group. His own creditors have a right to cause any of his property to be applied to the satisfaction of their claims. It may be that the law of the jurisdiction of incorporation gives the corporation a lien on the stock of a stockholder to secure debts of the stockholder to the corporation. Whether or not this is the case, creditors of the stockholder have the same legal recourse to his stock property that they have to any other property of his.

Question arises to what extent, if at all, these relationships change by reason of a sale of stock, accompanied by delivery to the purchaser of a properly endorsed power, before the transfer has been recorded on the books of the corporation. Corporation statutes contain such provisions as "The stock of a corporation *** shall be transferable only on the books of the corporation in such manner as the by-laws prescribe." And certificates of stock commonly have such clauses as "transferable only on the books of the company by holder hereof, in person or by his attorney, upon surrender of this certificate properly endorsed."

The relationship between a man who is a stockholder and one with whom he contracts to sell stock changes on their entering into the contract; it changes still further on delivery of a certificate properly endorsed. But to what extent are the relationships of the seller and the buyer to other people changed? Expressed in terms of ordinary sales of chattels, has there been a transfer of legal title to the thing contracted for?

Some jurisdictions have held that there has been no transfer of title until the entry of a transfer on the corporate records; others, probably more numerous, have held such entry not necessary for the transference of title. Consequently, if the buyer is not diligent, an attaching creditor of the seller would prevail over the buyer in those jurisdictions in which legal title did not change until entry of the transfer; and vice versa in the other jurisdictions. The principle would operate conversely with respect to an attaching creditor of the buyer.

CHAPTER XXV

Further Matters of the Transfer of Stock and Bonds

Twenty-four States (to 1935) have enacted the provisions of a bill (sometimes with modifications) commonly called the Uniform Stock Transfer Act, which, where adopted, answers the question raised at the end of the previous chapter, of title, and various other questions of stock transfer, and supersedes several rules of Common Law. With respect to title, i.e., the moment of change of relationships, it provides that title passes on the delivery of a certificate with a proper power for transfer on the corporate books. At the same time it preserves the value of the entry for the functioning of the corporate mechanism by providing that "nothing in this act shall be construed as forbidding a corporation — (a) To recognize the exclusive right of a person registered on its books as the owner of shares to receive dividends and to vote as such owner."

This provision also settles a question that might arise on the use of detached power. Assume that the buyer transmits to the seller the purchase price for a certain number of the shares of stock of a corporation, and the seller sends the buyer a detached power, but does not send the stock certificate. Later the seller contracts to sell the same stock to a man ignorant of the earlier transaction, and delivers the certificate with a signed power on the back to the new buyer. The first purchaser has acquired only one of the indecia of title; and the second purchaser, having in good faith acquired both, should prevail. The Uniform Stock Transfer Act, making delivery of both necessary for the transfer of title, provides that he does.

In fact, the act goes on specifically to provide that:

The title of a transferee of the certificate under a power of attorney or assignment not written upon the certificate, and the title of any person claiming under such transferee, shall cease and determine, if, at any time

prior to the surrender of the certificate to the corporation issuing it, another person, for value in good faith, and without notice of the prior transfer, shall purchase and obtain delivery of such certificate with the indorsement of the person appearing by the certificate to be the owner thereof, or shall purchase and obtain delivery of such certificate and the written assignment or power of attorney of such person, though contained in a separate document.

Furthermore the act deals with other matters we have discussed, and provides (Section 6) that:

The indorsement of a certificate by the person appearing by the certificate to be the owner of the shares represented thereby shall be effectual, except as provided in Section 7, though the indorser or transferror —

(a) Was induced by fraud, duress or mistake to make the delivery, or

(b) Has revoked the delivery of the certificate, or the authority given by the indorsement or delivery of the certificate, or

(c) Has died or become legally incapacitated after the indorsement, whether before or after delivery of the certificate, or

(d) Has received no consideration.

The act goes on in Section 7 to provide a remedy except in case of the bona fide purchaser, stating that:

If the indorsement or delivery of a certificate —

(a) Was procured by fraud or duress, or

(b) Was made under such mistake as to make the indorsement or delivery inequitable, or

(c) Without authority from the owner, or

(d) After the owner's death or legal incapacity.

(Then) The possession of the certificate may be reclaimed and the transfer thereof rescinded, unless

(1) The certificate has been transferred to a purchaser for value in good faith without notice of any facts making the transfer wrongful, or

(2) The injured person has elected to waive the injury, or has been guilty of laches in endeavoring to enforce his rights.

Any court of appropriate jurisdiction may enforce specifically such right to reclaim the possession of the certificate, or to rescind the transfer thereof, and pending litigation, may enjoin the further transfer of the certificate or impound it.

Going on, the act provides in Section 8 that:

Although the transfer of a certificate or of shares represented thereby has been rescinded or set aside, nevertheless, if the transferee has possession of the certificate or of a new certificate representing part or the whole

of the same shares of stock, a subsequent transfer of such certificate by the transferee, mediately or immediately, to a purchaser for value in good faith, without notice of any facts making the transfer wrongful, shall give such purchaser an indefeasible right to the certificate and the shares represented thereby.

Under the act, then, apparently no question arises as to whether the stockholder was negligent in the loss of his certificate. The bona fide purchaser is protected in any case. Also the matter of an endorsed certificate of stock in possession of the decedent at the time of his death is taken care of. Ordinarily the corporation can have no actual knowledge of the death, or that the endorsed certificate was not delivered before death. If, as provided by the act, the bona fide purchaser is the owner, the corporation should be protected in making the transfer.

The act also sets forth certain warranties of the seller in providing (Section 11):

A person who for value transfers a certificate, including a person who assigns for value a claim secured by a certificate, unless a contrary intention appears, warrants —

(a) That the certificate is genuine,

(b) That he has a legal right to transfer it, and

(c) That he has no knowledge of any fact that would impair the validity of the certificate.

In the case of an assignment of a claim secured by a certificate, the liability of the assignor upon such warranty shall not exceed the amount of the claim.

So it may be said generally that the operation of the Uniform Stock Transfer Act, where adopted, makes the position of a certificate of stock closely approximate that of a negotiable instrument.

If the purchaser of stock standing in the name of the seller takes delivery of a certificate not properly endorsed, the seller is under an obligation to give a proper endorsement. As expressed in the act (Section 9):

The delivery of a certificate by the person appearing by the certificate to be the owner thereof without the indorsement requisite for the transfer of the certificate and the shares represented thereby, but with the intent to transfer such certificate or shares shall impose an obligation, in the absence of an agreement to the contrary, upon the person so delivering to complete the transfer by making the necessary indorsement. The

transfer shall take effect as of the time when the indorsement is actually made. This obligation may be specifically enforced.

The remedy, therefore, is not confined to damages. Specific enforcement means that the court may order the seller actually to put the endorsement on. Failure to obey the order would be a contempt of court, punishable by imprisonment.

PROBLEMS OF TRANSFER ARISING ON THE DEATH OF A STOCKHOLDER

So far we have considered only the transfer of a share interest of a living stockholder. Death of a stockholder raises difficulties. Even though the certificate found among the securities is endorsed by him in blank the stock cannot, as we have seen, be transferred on this endorsement, since he had not actually authorized anyone to make the transfer. If he had delivered a power to someone to whom he had not sold or given the stock, the death of the stockholder would revoke the authority. To be sure, under the Stock Transfer Act, a corporation making the transfer in good faith, and a purchaser in good faith, would be protected. But they would have to be without notice of the death. On the other hand, if the owner had made a sale of the stock, or given it, and delivered the certificate with the power signed, the interest of the possessor of the certificate in the stock should cause the authority to survive the death of the record owner.

APPOINTMENT OF LEGAL REPRESENTATIVE

In the case of the stockholder of record dying while still the owner of the stock, only his legal representatives can properly effect a transfer. If the owner died leaving a valid will, the executor named in it qualifies as legal representative by causing the court having jurisdiction over decedents' estates to issue letters testamentary to him. Or, if the executor named in the will has died, or fails to qualify, the court, on proper application, will appoint an administrator with the will annexed; that is, one who is designated to settle the estate in accordance with the provisions of the will. If the owner of the stock died without leaving a valid will, the court, on proper application, will issue letters of administration to an administrator, who will settle the

personal estate in accordance with the law of distribution in the jurisdiction.

TRANSFER BY ADMINISTRATOR

Let us consider the intestate (without a will) situation first. The administrator, by virtue of his appointment, has authority to sell and transfer the stock. He signs the power of attorney on the back of the stock certificate, or a detached power, in his official capacity: "John Jones as administrator of the estate of Henry Smith, deceased." Unless he is offering the stock for transfer to himself, the corporation need not inquire into the propriety of his transaction.

TRANSFER BY EXECUTOR

But if the decedent left a will the situation is different. He may have bequeathed this particular stock to a designated legatee, or otherwise left instructions with respect to it. The corporation must take cognizance of the existence of the will, and not make any record of transfer contrary to its operation. The corporate agent for transfer must examine the terms of the will, and for this purpose may properly require the production of a true copy, certified as such by the clerk of the court in which it was probated. If the agent does not find the stock specially disposed of, the agent will transfer the shares, just as it would on the authority of an administrator; but if there are operative provisions in the testament, the agent will transfer only in accordance with them.

LETTERS OF ADMINISTRATION AND LETTERS TESTAMENTARY

Of course the corporation will require evidence that the person signing the stock power has in fact been appointed executor or administrator. For this purpose the clerk of the court which made the appointment issues a certificate of letters of administration, or letters testamentary, as the case may be. This certificate states the fact and date of appointment, that the letters have not been revoked, and that the person named is still acting. Since it is possible for an executor or administrator to resign, or to have his letters revoked for cause, the corporation will require that the date of the issuance of this certificate, which appears on it, be

fairly recent. In practice certificates several weeks old are accepted. An effective resignation or a revocation of letters for cause takes some time.

CONSENT OF TAXING AUTHORITY

After the death of a man (as well as before) there is an interest in his property, besides the interests arising out of testamentary or contractual relationships, or the status of kinship. It is the interest of the State. The law of the State creates, and its sanctions establish, property. Of course the word "property" is used here in its strict sense of rights, and not in its popular sense as synonymous with "wealth." Among the property rights which the State creates, and establishes by its sanctions, is that of devolution on death to the permitted beneficiaries.

EXCISE ON DEVOLUTION

Devolution is sometimes called a "privilege," in distinction from "rights" creating property during the life of the possessor of these rights. Since all the members of the body politic enjoy the benefits of devolution, it hardly seems a privilege in any proper juristic sense. The matter is not important for present purposes. The fact is that, on the death of a property owner, the State steps in and levies an excise on the devolution, i.e., appropriates part of the values for the public use. Sometimes the situation is thought of on an analogy to the theory of the feudal system, that all lands in the kingdom (State) belong to the crown (sovereign), are held on grant of the crown, and, except by permission of the crown, revert to it on the death of the grantee. The more fundamental juristic concept that all rights depend on sanctions of State, however, serves the purpose better.

STATE PROHIBITS CORPORATION TO TRANSFER DECEDENT'S STOCK UNTIL STATE CONSENTS

In the process of making effective the excise on the permitted devolution, the State prohibits corporations over which it has jurisdiction from transferring stock of decedents without its consent. So we have another requirement for the transfer of such stock — the consent of the State. With the area of modern

economic operations so commonly not limited by political boundaries, question immediately arises of what State may compel its consent.

WHERE DOES THE DEVOLUTION TAKE PLACE?

Any State in which a corporation has property, or "does business," for that matter, can take effective jurisdiction over the corporation. For many years not only States of incorporation, but also States in which the corporation had property, claimed jurisdiction to tax (levy the excise), on the ground that there was a devolution of capital stock in the State. It was the puzzling problem of the situs (the place of existence) of an intangible or non-physical thing.

What changes ownership on death? The answer is — the right of a stockholder with respect to the capital stock of a corporation. It was argued that wherever there was wealth giving rise to value in capital stock, there was in that place a devolution of rights in that value. Contra, it was argued that the rights were the rights of the deceased stockholder and existed only in the jurisdiction of the residence of the stockholder.

For many years States in which the corporation had property, other than those of the residence of the deceased stockholders, put into effect their claim of a right to tax. Finally, however, the Supreme Court of the United States in the case of the First National Bank of Boston against the State of Maine (1932) settled the matter by deciding that only the State of residence of the deceased stockholder had jurisdiction to levy the tax.

Some States having jurisdiction over the corporation, by reason of corporate property in the State, still claim jurisdiction to require their consent to the transfer of stock of decedents who were not resident in that State, even though they cannot tax the devolution. Presumably their reason for doing so is that, through their requirement of information as a condition of giving the consent, they may discover that the decedent owned tangible property in the jurisdiction, the devolution of which they can tax.

WAIVERS

In practice the State of the residence of the decedent consents to the transfer on the disclosure of the asset. It has jurisdiction over the legal representation of the decedent, the administrator

or executor, and through its power over him can attend to the collection of the tax. Other States, before the decision in the case of First National Bank against the State of Maine, required and, on discovering the existence of tangible property of the decedent in the jurisdiction, still may require the payment of any tax found due before consenting to the transfer. In the experience of the writer one State, without jurisdiction to tax, nevertheless requires the payment of a fee for the issuance of the consent. Possibly others make a like requirement. The consent to transfer is called a "waiver."

So the executor or administrator must procure and present to the corporation waivers from all States claiming jurisdiction over the corporation for the purpose of consent.

FEDERAL ESTATE TAX

Operation of the estate tax, which the Federal Government imposes on the transfer of the net estate of a decedent, need not be discussed. The Federal Government does not impose any restrictions on the transfer of stock, but relies on its jurisdiction over the person of the executor or administrator.

SUMMARY OF REQUIREMENTS FOR TRANSFER OF DECEDENT'S STOCK

Summarizing the requirements for the transfer of stock on the books of a corporation by an executor, there should be presented to the corporation:

(1) Certificate of recent date of letters testamentary, showing the date of the issuance of letters, stating that they have not been revoked, and that the executor is still acting. The corporation may keep this in its records of the transfer or may merely enter a notation of it and return it to the executor. The court fee for issuing this is small — say, twenty-five or fifty cents.

(2) A true copy of the will, certified as such by the clerk of the court in which the will was probated. Since the cost of certification is likely to be several dollars, the transfer agent of the corporation will return this. But the corporation may require that an uncertified copy be furnished to it, which it may keep. If the will imposes no restrictions, the corporation may not require the copy to keep, but may merely make a notation on its records

of the exhibition of the will and the fact that it does not restrict the transfer of stock.

(3) Waivers from the tax departments of all States claiming and exercising jurisdiction over the transfer. These waivers refer to the specific number of shares of the specific class or classes of stock to be transferred, and the corporation retains them for its records of the transfer.

(4) Surrender of the stock certificate, with an assignment and power of attorney signed by the executor as acting in his fiduciary capacity.

Requirements for the transfer of stock of a decedent by the administrator correspond, except that there is no will.

If there is more than one administrator, all should execute the power. In the case of more than one executor, it is expedient at least that all should execute. Though a single executor has authority to perform administrative acts, not requiring judgment or discretion, the sale of stock seems certainly to require the exercise of judgment, and the transfer is for the purpose of carrying through the sale. Endorsement by all the fiduciaries shows that all have consented to the sale.

TRANSFERS BY TRUSTEES

Stock may be held under the terms of a trust. A man may establish a trust by an instrument called a declaration of trust; or he may cause it to be established on or after his death by the terms of his will. In the latter case it is called a testamentary trust. With respect to stock transfers, question arises as to whether the trustees have express or implied authority to sell the stock, and whether otherwise the terms or operation of the trust instrument imposes any restrictions on its transfer. The stock should stand in the name of the trustee as fiduciary, i.e., as "John Jones, trustee," to earmark it clearly as not being the property of Jones in his own right exclusively. And he should execute the power to transfer "as trustee," with such further identification of the trust as may be desirable.

On a testamentary trust, letters of trusteeship issue from the court in which the will was probated. The transfer agent will require:

(1) Surrender of the stock certificate, with a stock power executed by the trustee in his fiduciary capacity, i.e., "as trustee," etc.;

(2) A recently dated certificate by the clerk of the court of the issuance of letters of trusteeship;

(3) A copy of the will certified by the clerk of the court;

(4) And if the stock is being transferred to the beneficiaries of the trust, the transfer agent may require evidence that the State has no unsatisfied tax claim against the stock.

If the transfer is of stock held under a declaration of a trust established while the creator of it was living, the corporation will require, instead of a certified copy of a will, inspection of the declaration of trust, and a copy of it to keep, or at least the relevant parts of it.

If there is more than one trustee, execution of the stock powers by one of the trustees is not enough. All must sign.

GUARDIANS OF INFANTS AND GUARDIANS OR COMMITTEES OF INCOMPETENT PERSONS

Infants may repudiate certain of their contracts; and incompetent persons do not have the capacity to make contracts. So one cannot contract safely with an infant, and cannot contract with an incompetent. If infants or incompetents own property requiring to be dealt with, it is customary for their next of kin or other proper person to procure the appointment by the court having jurisdiction of a Guardian of the Property of an infant, or, in the case of an incompetent, the appointment of a fiduciary who is called in some States a Committee of the Property, in others, as in the case of an infant, a Guardian of the Property.

An infant or an incompetent is a ward of the court; and the fiduciary an agent of the court in the care of the ward's property. His situation is different from that of a trustee. In law the property of the trust is the property of the trustee, who owns it, however, not for his own benefit, but for that of the beneficiary of the trust. In the case of infancy or incompetency, the infant or incompetent owns the property. The fiduciary (under the authority and direction of the court) manages it.

Strictly, if stock is owned by an infant or incompetent, it should stand in his name with the addition of the name of the fiduciary as: "John Jones, Infant, Henry Smith, Guardian of the Property." It is common enough, however, to have the entry as though Smith were a trustee, as "Henry Smith, as Guardian of John Jones, Infant." The stock power should be executed in the name

as it appears in the face of the certificate, i.e., as "John Jones, by Henry Smith, Guardian of the Property," or, if the stock has been entered in the trustee form, "Henry Smith, as Guardian of John Jones, Infant." The corporation should be satisfied that the fiduciary has authority to transfer. This is so much a question of the law of the particular jurisdiction that it will not be discussed here. Since the Guardian or Committee derives his authority by appointment of the court, the corporation will require certificate of appointment as in the case of an executor or administrator.

FIDUCIARY TRANSFERRING TO HIMSELF

Since a fiduciary may not sell to himself property affected with his fiduciary relationship, without the consent of those to whom he stands in that relationship, a corporation will not transfer such stock without being satisfied that the fiduciary has adequate authority. An infant or an incompetent cannot give a binding authority, and the corporation will require the protection of a court order if such a person is affected. Of course, it may be that the terms of a trust instrument give the trustee authority to transfer to himself. In that event a court order would not be required.

TRANSFERS BY A CORPORATION

If one corporation owns stock of another corporation, the problem of transfer is one of evidence of the authority of those who purport to act on behalf of the owning corporation. We have seen that a number of people may unite, form a group, and agree on a common agent to act for them; and that the law of the corporate form of enterprise requires that the stockholder group act only by the designation of agents. Each member by joining the group consents that the majority may be agent, so to speak, for all, and a sub-agent, appointed by the majority, also be agent for all. So in all corporate action these questions constantly arise: (1) Have agents been duly designated (i.e., in accordance with law and the corporate charter and by-law)? (2) Are the people purporting to act for the group those who have been designated to act in the matters to be transacted? One needs always to keep in mind that valid corporate action depends on the effective delegation of adequate authority.

EVIDENCE OF AUTHORIZATION OF OFFICERS OF CORPORATION PRESENTING STOCK FOR TRANSFER

By-laws of the corporation may contain a provision indicating the officers authorized to transfer stock owned by the corporation. If this is the case, the transfer agent of the corporation, stock of which is to be transferred, will require a copy of the covering by-law, certified by the secretary under seal of the corporation presenting the stock for transfer. The agent will require a further certificate of the names of persons holding the corporate offices indicated in the by-laws, and of their signatures. That is, if the by-laws gave authority to the president or a vice president and the treasurer or an assistant treasurer, the secretary would certify that James Robinson was president; Thomas Brown and Henry Jones, vice presidents; Richard Hill, treasurer; and John Ingraham, assistant treasurer, and that the signatures appearing below were the signatures of these men.

If the by-laws of the corporation fail to indicate officers authorized to act for a transfer of stock owned, the directors will have to adopt a special resolution granting the authority. Since the transaction is business of the corporation, and the directors have general authority from the stockholders to conduct the corporate business, their resolution, designating the persons authorized to cause the transfer of stock owned, would be adequate authority. As before, the transfer agent will require a properly certified copy of this resolution, and of the names and signatures of the persons authorized to act under it.

TRANSFERS BY PARTNERSHIPS

Since each general partner is general agent of the firm for partnership business, a signature of the firm name by one of the general partners is authority for the transfer of stock.

It is of special interest in this connection that most of the stock brokerage business on the organized exchanges is done by partnerships which are represented on the board by one or more of their number who are members of the exchange. For margin accounts the brokers hold the stock belonging to their customers as security for the loans by which the stock is carried. They can hold non-dividend paying stocks between the periods of dividend declaration, in the form of street delivery certificates, i.e., certificates endorsed in blank by the record holder.

Holding dividend paying stock in that form over the date for making up the stockholder list for dividend distribution would result in the dividend going to the stockholder of record and not to the true owner. A broker carrying stock on margin cannot safely have it transferred into the name of his customer. He would then have to get his customer to endorse the certificate in blank, for unless it is transferable it is obviously not good collateral, because it cannot be sold. The customer might not be readily available to endorse; and if available, he might refuse his signature. Either situation would be embarrassing for the broker.

Under authority given by the customer on opening the account, the broker, in anticipation of a dividend stock list date, gets the stock transferred into the name of the brokerage firm, which credits the dividend to the customer's account. This situation of course accounts for the fact that the names of stock exchange firms appear among lists of the largest stockholders of corporations. The number of shares of stock of a corporation in the names of brokers gives a substantial indication of what is called the floating supply; that is, of the shares which are being held speculatively, and therefore more likely to be offered for sale, with the consequent effect on price.

JOINT TENANCIES AND TENANCIES IN COMMON

Stock might be entered in some such manner as this: "John Jones and Henry Smith or the survivor." Such an entry indicates what is called a joint tenancy. In the event of the death of one, the entire ownership passes to the survivor. As long as both are alive, both must endorse. On the death of one, transfer is made on proof of the death, and the signature of the survivor. Courts are still dealing with the problem of whether or not there is a taxable devolution.

If the entry is simply "John Jones and Henry Smith," presumptively they are tenants in common. On the death of one, his interest does not pass to the other, but to the executor or administrator of the decedent. As long as both are alive, both must endorse. In the event of a death, transfer will be made on the signature of the survivor and the same papers from the legal representative of the decedent as would be required for a transfer of stock solely by the decedent. Here there is undoubtedly a taxable devolution of the decedent's interest.

TRUSTEE IN BANKRUPTCY OR ASSIGNEE FOR THE BENEFIT OF CREDITORS

If a man has been adjudicated bankrupt, or if he has made voluntary general assignment for the benefit of creditors, he has parted with control over his property; and the operation of the law has vested that control in the assignee under the assignment, or in the trustee in bankruptcy. A corporation will transfer only on the authority of the assignee or trustee, and will require appropriate evidence of the general assignment, or the appointment of the trustee.

NOMINEES

Difficulties involved in the transfer of stock owned by corporations, and stock in the ownership of more than one individual, often cause the owners to have the stock registered in the name of an individual. He is commonly spoken of as their "nominee." Essentially he holds the stock in trust for those to whom it really belongs, and by their consent enters it in his own name without earmarking as trustee stock.

DESTROYED OR LOST CERTIFICATES

What happens when a certificate is destroyed or lost? The stockholder is the owner of record in the books of the corporation. It will continue to pay dividends to him, and otherwise to treat him as a stockholder. But if he should want to sell he has no certificate to deliver, and no one will pay him for stock without receiving a certificate representing it.

Statutory and by-law provisions frequently present governing regulations. Speaking broadly, the corporation must issue a new certificate to the stockholder on adequate evidence of destruction or loss, and a bond of the stockholder, with adequate surety, to indemnify the corporation in the event of presentation of the original certificate by one who has a right to transfer.

The Uniform Stock Transfer Act deals with the matter by providing:

> Where a certificate has been lost or destroyed, a court of competent jurisdiction may order the issue of a new certificate therefor on service of process upon the corporation and on reasonable notice by publication, and in any other way which the court may direct, to all persons interested,

and upon satisfactory proof of such loss or destruction and upon the giving of a bond with a sufficient surety to be approved by the court to protect the corporation or any person injured by the issue of the new certificate from any liability or expense which it or they may incur by reason of the original certificate remaining outstanding. The court may also in its discretion order the payment of the corporation's reasonable costs and counsel fees.

The issue of a new certificate under an order of the court as provided in this section, shall not relieve the corporation from liability in damages to a person to whom the original certificate has been or shall be transferred for value without notice of the proceedings for the issue of the new certificate.

Of course a corporation may of its own volition issue a new certificate. Whether with or without court order, it will require the protection of the bond of the stockholder, presumably with a surety or sureties. The situation arising on the destruction or loss of a certificate is a difficult one. The corporation is never completely protected. Evidence of the destruction of a certificate may be very strong; nevertheless it may not be destroyed. A stockholder may be honestly confident that he had not endorsed a lost certificate, yet be mistaken.

When a holder of a properly endorsed certificate presents it to the corporation, it must transfer. Meanwhile the stockholder who procured the issuance of the new certificate may have sold his stock, so that the corporation cannot reclaim from the original stockholder, but can only hold him on his indemnity bond. He may be insolvent. If he does not pay, the corporation has recourse against the surety. However good the surety may have seemed at the time of the delivery of the bond, it may be insolvent by the time the liability ceases to be contingent.

Issuance of the additional certificate might even result in the embarrassment of an overissue of stock in the event of a presentation of the original certificate by a bona fide purchaser. Yet, in spite of all these difficulties for the corporation, it is probably on the whole desirable that the stockholder should have the right to procure a new certificate on proof of loss. Sometimes the evidence of destruction or irreparable loss is beyond a reasonable doubt, as in the case, for example, of a careful record of shipment on a vessel sinking in midocean without salvage. Yet, even in such case, the loss is not absolutely certain. A fraudulent person making up the record might have stolen the certificate.

THE SURETY BOND

Regularly the bond furnished the corporation to procure a reissue of lost instruments carries the suretyship of a surety company. Such a company, with an office in the financial district of New York City, may write twenty of these bonds a week. They may cover loss up to a specific sum, or may be open account bonds, covering the loss to the corporation, whatever it may turn out to be. No one can tell what stock may be worth one year away, to say nothing of five, ten, or more years. Property in a share of stock is not just a contract claim. There is no statute of limitations to be pleaded against a right of ownership.

Following the rules of the Association of Registrars and Transfer Agents, all the large corporations having New York City banks or trust companies as transfer agents demand bonds in open amounts, i.e., without limitation of the liability. Under present rates, the surety company receives a premium of ten per cent on the market value of the shares at the time the bond is written, with a minimum of $10. And this is not an annual charge, but a single premium for the entire risk. Premiums do not vary either with the circumstances surrounding the loss of the instrument, or the financial responsibility of the principal on the bond. A company would refuse to accept a risk that seemed too great.

Obviously the risk on a lost certificate endorsed in blank is much greater than on one not in this quasi-negotiable form. If the lost certificate was endorsed in blank, the surety company requires that the new certificate be left with it for a period of years, usually five. It must rely on the affidavit of the principal as to the form of the lost certificate.

What has been said about security for lost stock certificates applies also to security for lost bonds.

TRANSFER AGENT AND REGISTER OF TRANSFER

A corporation with a relatively small number of stockholders, and infrequent transfers, generally leaves the matter of transferring its shares in the hands of the officer who, under statute or by-laws, has custody of the stock records. Corporations with a larger number of stockholders, and more frequent transfers, make special provisions for them. The very largest, like the United States Steel Corporation, may establish their own special depart-

ments or transfer offices. More commonly, however, corporations making many transfers designate some bank or trust company as "transfer agent." A complete corporate set-up for transfers includes also a "registrar of transfers." Some banks, trust companies, and "corporation companies" have many of these agencies, and their work makes a substantial department.

The term "transfer agent" is completely descriptive: a trust company so acting is simply the agent appointed by the corporation to make the transfers of its stock. A registrar of transfers acts essentially as an auditor of the work of the transfer agent, guarding against errors and especially against the overissuance of stock.

If a corporation has designated both a transfer agent and a registrar of transfers, its stock certificates contain some such clause as: "This certificate is not valid unless countersigned by the Transfer Agent and registered by the Registrar of the Company"; and they contain blanks, which may be placed across the ends of the face of the certificate, for the signature of the transfer agent, and the notation of registry to be signed by the registrar.

COURSE OF A TRANSFER

Let us follow through the course of making a transfer on a sale by John Jones of 100 shares of the stock of Commercial Products Corporation, of which Jones owns 200 shares represented by one certificate in his name. We will assume that he is selling the stock on a stock exchange through his brokers, Brown and Robinson. He has instructed them to sell 100 shares, and has delivered to them the certificate for 200 shares, out of which the sale is to be made. On delivering the certificate, he signed the instrument on the back, leaving the space for the assignee and the number of shares blank. He might have filled this in himself, but, through laziness or ignorance of just how, he has not done so.

His delivery of the certificate with this blank authorizes the broker to fill it in so as to carry through the transaction in accordance with instructions. The brokers enter the blank "transfer unto John Jones 100 shares and to Brown and Robinson 100 shares." Since only part of the shares represented by the certificate are being sold, it cannot simply be endorsed in blank and delivered to the brokers acting for the purchaser as a street delivery. The selling brokers must have a certificate representing

100 shares to deliver. Even though they may already have made the contract of sale, they cannot safely have a certificate issue in the name of the purchaser's broker. So they have the certificate to be delivered issued in their own name, relying on their instructions, actual or implied, to go ahead and complete the transaction without troubling their customer further for authority to take title in their own name. If their customer has a margin account with them, they may have authority expressed at the opening of the account.

The brokers endorse a guarantee of the genuineness of the signature of Jones, and send the certificate over to the transfer agent, which gives a receipt to the messenger. When satisfied that the transfer is in order, the agent prepares and signs the two new certificates, and sends them to the registrar of transfers with the surrendered certificate. There, the new certificates are examined to see that the number of shares they represent does not exceed the number of shares represented by the old certificate.

Proper entries are made in the registrar's records of the surrender and cancellation of the old certificate, and the issuance of the new ones. The registrar signs the new certificates, and returns them with the canceled old one to the transfer agent. The agent files the canceled certificate in its records, and delivers the new certificate to the messenger of the stock exchange firm on presentation and surrender of the receipt for the old certificate.

Since the work of the registrar of transfers is essentially that of an auditor of the work of the transfer agent, there is no point in designating the transfer agent "transfer agent and registrar," as is sometimes done when no separate agency is designated as registrar.

Corporate mechanism for the transfer of stock has been so developed that it is possible for a corporation to have its stock listed and actively dealt in on the exchanges of several cities. The corporation appoints a transfer agent and registrar in each city; and each transfer agent daily transmits to the other transfer agents its list of transfers; and each registrar to the other registrars its list of registrations.

Owing to the use of bearer stock certificates in Europe, and the slowness of communication by mail, to enable European stocks to be dealt in on American exchanges, and vice versa, the actual share certificates are deposited with a trustee, and its registered certificates of beneficial interest issued against them are listed. In

Europe bearer certificates of the trustee are issued against the American stock entered on the books of the corporation in the name of the trustee.

BONDS

For consideration of the transfer of bonds we must distinguish those in the bearer or coupon form from those in the registered form.

COUPON BONDS

Coupon bonds may be negotiable instruments.

As stated in the Uniform Negotiable Instruments Law:

> An instrument to be negotiable must conform to the following requirements:
>
> 1. It must be in writing and signed by the maker or drawer;
> 2. Must contain an unconditional promise or order to pay a sum certain in money;
> 3. Must be payable on demand, or at a fixed or determinable future time;
> 4. Must be payable to order or bearer; and
> 5. Where the instrument is addressed to a drawee, he must be named or otherwise indicated therein with reasonable certainty.

We are not here concerned with (5). An instrument in the form of a bill of exchange, though drawn by a corporation, is not a corporation bond.

Since, in practice, corporation bonds are not made payable to order, we will not concern ourselves with a discussion of bonds that might be so issued.

But coupon bonds, both the face of the bond and the coupons attached, are payable to bearer. If they do not contravene any of the requirements for negotiability, they are negotiable.

Bonds, to be sure, are instruments under seal, and at Common Law sealed instruments were not negotiable. The courts, however, had pared away this principle with respect to corporate securities; and the Negotiable Instruments Act provides that a seal does not impair negotiability.

The requirement for negotiability that an instrument must contain an unconditional promise or order to pay a sum certain in money is more troublesome. Corporation bonds are usually issued pursuant to the terms of an elaborate trust indenture (the corporation mortgage, if it is a mortgage instrument). They

regularly refer to the indenture in some such way as: "to which indenture reference is hereby made for the terms and conditions upon which said bonds are issued and secured." Questions arise as to whether any provisions of the indenture amount to making the payment conditional; and as to how far courts will go in construing general reference in the bonds to the indenture as making any such conditions binding on the bondholder. We will not go on with a consideration of the problem, but will let it rest with this reference to its existence.

If, however, the negotiability of a bearer coupon bond is not impaired by conditions, it is a negotiable instrument, and all the principles of negotiability apply to its transfer. A purchaser for value before maturity without notice acquires good title; and a purchaser with notice and after maturity, other than one who participated in the wrong, who purchases from a bona fide holder takes his rights. Since a stolen bearer bond is a completed instrument when stolen, the bona fide purchaser prevails, as he also prevails in the case of a lost bearer bond. But the law of negotiable instruments is extensive, and will not be gone into further here.

REGISTERED BONDS

A registered bond does not contain the words of negotiability "pay to the order of," but promises to pay to ——, or registered assigns; or makes an equivalent promise. It contains some further provision as: "This bond is transferable only in the manner prescribed in said indenture on the books of the Company at its office or agency in the Borough of Manhattan, upon surrender and cancellation of this bond." The indenture prescribes the manner of transfer in some approximation of the following statement: "Whenever in person or by his duly authorized attorney the registered holder of any registered bond shall surrender the same for transfer, accompanied by a written instrument of transfer in form approved by the Company, the Company shall issue, and the Corporate Trustee shall authenticate and in exchange for such registered bond or bonds shall deliver a new registered bond or bonds for a like aggregate principal amount."

The "written instrument of transfer" would be in substantially the same form as an assignment and power of attorney for stock.

Such registered bonds are not negotiable instruments. If the owner should execute an assignment, leaving the name of the

authentication of the trustee; stock certificates may have the countersignatures of the transfer agent and the registrar of transfers. These devices, however, are more especially directed against improper issuance by officers of the corporation.

Careful preparation of the security itself is protection. Engraving requires a skilful engraver for its imitation, and skilful engravers are not numerous. It is a requirement for listing in the New York Stock Exchange that the securities be engraved.

We are all familiar with the red thread in paper currency of the United States as a precaution against forgery. The government reserves the use of such paper to itself. At least one of the security printing companies, however, makes use of a similar device in specially prepared paper.

Engraving the extensive amount of reading matter appearing on a bond, and on some stock certificates, is an expensive matter and requires time. Unless the corporation is listing its securities, its officers may feel that the cost is not justified. To meet a desire for protection at less cost, a security printing company has engraved background plates, against the impression of which on the paper it will print the legend set up in type. Though the plate is not used exclusively for the issue of the particular corporation, the printing company safeguards its possession; and its use presents to the forger all the difficulty of an engraved background. A careful printing company not only safeguards the plates, but exercises extreme care to prevent a blank in any stage of its progress from going astray.

Sixth Section

Marketing Securities

CHAPTER XXVI

Providing Additional Capital by Sale of Shares to Stockholders

A corporation may seek additional investment financing from its own stockholders. Indeed, if the directors propose to increase the corporate assets by selling stock, as opposed to creditor securities, usually, as we have seen, they are under legal obligation to appeal to the members of the corporate group. It may be taken as the general principle that stockholders have a right to subscribe, in proportion to their holdings, to an additional issuance of shares. As a basis for considering additional capital provision by an appeal to stockholders, let us review here several matters we have discussed in various places. Though repeating, we will see these matters now from the viewpoint of the corporate management appealing to the stockholders for further funds. Of course anything said about preëmptive rights is subject to limitation with respect to shares issued for property other than cash.

CONTRACTING AGAINST PREËMPTIVE RIGHTS

Though the preëmptive right exists, presumably it is within the field of contract, and may be surrendered by agreement. Statutes, as we have noted, may expressly so provide, as in Delaware, which has enacted that: "The certificate of incorporation may also contain such provisions as may be desired, limiting or denying to stockholders the preëmptive right to subscribe to any or all additional issues of stock of the corporation of any or all classes."

EQUALITY OF CLASSES OF SHARES AS TO RIGHTS

On the general principle that any one share of stock has the same rights as any other share unless express agreement to the

contrary appears, the holder of shares of one class of stock would have the right, in the absence of specific stipulation, to subscribe on an issuance of shares of any other class. Such a right may be quite contrary to the interest of the incorporators, who more probably meant that preferred stockholders should have a right to their expressed preferences as to dividends and, on liquidation, as to assets, but should not in any way, direct or indirect, participate in profits beyond the stipulated rate. A right in a preferred stockholder to subscribe to an additional issuance of common shares would result in his obtaining an additional participation in profits. We are simply presenting a principle without attempting to indicate or predict the law of any jurisdiction.

If the rule of equality of shares in all respects not expressly restricted obtains fully, then, for example, the holder of preferred stock of the par value of $10 a share would have the same right to subscribe to additional common stock as the holder of a share of the common stock of the par value of $100 a share. The capital stock clauses of a certificate of incorporation should fully set forth any intended limitation of preëmptive rights with respect to any class or classes of stock.

Presumably the organizers of a corporate group, if the matter were brought to their attention, would desire the common stockholders to have a preëmptive right as to other classes of stock, but that the holders of other shares should have no preëmptive right at all, or one limited to stock of their own class. Perhaps the organizers would wish to give each class of stockholders a preferential preëmptive right in stock of that class. Often the conferences preliminary to drafting the certificate of incorporation do not thrash out the matter as fully as they should.

SUBSCRIPTIONS AT PAR — NO PAR SHARES

Generally the right is to subscribe at par. That is, even though the stock of a par value of $100 a share may be selling in the market at the price of $150 a share, the directors could not fix the subscription price for existing stockholders at $125 a share. It is rather illogical that on the original opening of the books for subscription to par value stock the directors could set the terms at par plus a contribution to paid-in surplus of $25 a share, but subsequently must give the stockholders who paid $125 a share for their original stock an opportunity to subscribe to an addi-

tional issuance at $100 a share. The rule presents one more difficulty with the theory of a constant in equality of contribution. There seems to be no sound reason why directors should not be permitted to create in this way a paid-in surplus at a time subsequent to the original issue of stock. Other than for this purpose of paid-in surplus, the matter is not very important, and results only in a larger numeral representing the degree of divisibility of ownership.

If no par shares represent the corporate stock, the directors may determine the subscription price at any amount they deem expedient. One may well consider this as an advantage of no par stock. It increases the possibility that the directors may successfully appeal to stockholders for additional contributions under a much wider range of circumstances. The directors may not sell par stock to the stockholders or anyone else for less than par; they may sell no par stock to stockholders for any price whatever; and as long as the corporation has substantial values in excess of creditor liabilities they will be able to make an offer to stockholders attractive enough to win acceptance.

The reason given for the right of the stockholder to subscribe to an additional issue in proportion to his holdings is that he should have an opportunity to preserve his proportionate interest in the enterprise. In the contemporary development of the corporate situation, this form of presenting the reason hardly discloses the real values involved in the right. It affords stockholders a protection against inequitable action on the part of directors selling stock for cash, other than pro rata to stockholders, for less than it is worth. Yet though a stockholder has the right to subscribe, he may not have the ability. If he does not have the funds to make payment, he cannot subscribe.

EXCEPTION OF PAYMENT FOR PROPERTY OR SERVICES IN STOCK

Another situation also vitiates the right. It is generally held that the directors may issue stock to pay for services or property without first offering the new shares to the stockholders. Reasons given for this limitation on the stockholders' right are hardly satisfactory — as that the stockholders are all equally benefited by the purchase. The limitation seems to rest really on convenience, as more expedient that the directors should have freedom

of action in this respect than that the stockholder should have an unlimited right.

WAIVING RIGHT

Just as the right may be contracted away through the provisions of the certificate of incorporation, also it may be waived. For example, in the promotion stages of an enterprise the members of an initial small group of stockholders may sign waivers of their right to subscribe, leaving the directors a free hand in the disposition of the stock. In a particular situation this may be a simpler way of establishing that all rights have been satisfied or cut off than having the record show that the stockholders were given an opportunity to subscribe and did not utilize it. With the waiver, the stockholder's own signature is in the record. Such a use of the waiver is entirely a matter of convenience. It is seldom that anyone would desire that a stockholder should not exercise his right. Obviously, if the group of stockholders is numerous the waiver is not a practicable means of making the record. And, presumably, the waiver is good only for the immediate issuance.

STOCK OPTIONS AFFECTING RIGHT

Granting an option to purchase stock may also cut off subscription rights to the stock under option. Presumably such an option, to be effective, may be given only on the unanimous consent of the existing stockholders, or on a waiver by them, or after they have had an opportunity to subscribe which they have not utilized. But once given, it is effective even against those who may subsequently become stockholders without any knowledge of the existence of the option. (*Kingston v. Home Owners Loan Insurance Company of America*, Del. 101A898.) No provision of the Federal Securities Act of 1933 is more salutary than the one requiring the prospectus in connection with an issue to contain "a statement of the securities, if any, covered by options outstanding or to be created in connection with the security to be offered."

EXAMPLE OF CREATION OF RIGHTS

With this review of the legal basis of the stockholder's preëmptive right, let us consider its effect in operation. For the sake of

simplicity we will examine first the case of par value stock. Assume stock of the par value of $100 a share, part of an outstanding issue of $10,000,000 par value, selling in the market at $150 a share. Whatever the balance sheet may show, the market evaluation of the corporate values in excess of creditor liability and the capital stock fund estimates it at $5,000,000. Assume that the authorized stock is ample and that the directors, desiring to increase the corporate assets by $2,000,000, propose to issue 20,000 shares of stock for that purpose.

EFFECT OF EXERCISE OF RIGHTS ON SHARE VALUE

Since 100,000 shares represent the existing capital stock, an issuance of 20,000 shares more is an increase of one share for every five outstanding. Assume that the stockholders subscribe for all the additional shares at the required price of $100 a share. Since the payment will be in cash, the corporate values will increase by $2,000,000. Before the issuance of the additional shares we have this situation:

Market estimate of value of capital stock and surplus	$15,000,000
Number of shares outstanding	100,000
Market value per share	$150

With the increase in values by the addition of $2,000,000 cash through the issuance of 20,000 shares we will have this situation:

Computed value of capital stock and surplus	$17,000,000
Number of shares outstanding	120,000
Computed value per share	$141.66⅔

POSSIBLE LOSS OF VALUE TO INDIVIDUAL STOCKHOLDER THROUGH FAILURE TO SUBSCRIBE

If we assume that the market price will accurately reflect this computed value, the owner of five shares of stock has a right to acquire for $100 an additional share with a market value of $141.66⅔. Actually, he gains nothing by his subscription; but

he may lose if he does not subscribe. He does not gain because he pays his full pro rata amount of the increase in the corporate values. He is essentially in the same position he would be in if a stock dividend were declared, which in fact only changes the number of his shares without changing their aggregate value at all.

Yet, if he does not subscribe he may suffer a diminution of value. Assume that he owns 100 shares, entitling him to subscribe to twenty shares, which, however, he does not take, though all the other stockholders subscribe to the full extent of their right, and the directors do not issue the twenty shares to anyone else. Then the situation would be different by $2000 less paid into the corporation and twenty shares less issued, and would appear as follows:

Computed value of capital stock and surplus	$16,998,000
Number of shares outstanding	119,980
Computed value per share	$141.67 +

So the result would be that his 100 shares, which had formerly a market value of $15,000, now have a computed value of $14,167. He has suffered a loss in value of $833, which the holders of the other 119,880 shares have gained.

VALUATION OF RIGHT

We will describe the shares existing before the issuance of the additional stock as old shares, and the shares after the additional issuance as new shares. Speaking in terms of the value of a right, we then have this situation:

Computed value of new share	141.66\frac{2}{3}$
Subscription cost of new share	$100.00
Value of new share above subscription cost	41.66\frac{2}{3}$
Number of old shares necessary to confer right to subscribe to one new share	5
Value attaching to each old share of subscription rights arising on additional issuance	8.33\frac{1}{3}$

For purposes of easy computation the whole matter can be reduced to a per share unit basis:

Market value of five old shares at $150 a share	$750.00
Corporate increase on issuance of one additional share	$100.00
Computed value of six new shares	$850.00
Value of one new share	$141.66⅔
Cost of additional share	$100.00
Value of rights accruing to five old shares	$41.66⅔
Value of right accruing to each old share	$8.33⅓

It is sometimes said that the creation of stockholders' rights effects "a dilution of the surplus."

PROCEDURE ON THE CREATION OF RIGHTS

We will continue our consideration of stockholders' rights on the basis of an outstanding issue of substantial size, for the shares of which a ready market exists. Under these circumstances, the stockholder who is not in a position to furnish the funds for a subscription to additional stock, or who does not wish to increase his invested commitment to the particular enterprise, can escape loss. In explanation, let us follow through the actual process of the issuance of the additional stock. A board of directors expresses its decision to increase the capital stock of the corporation by a resolution in form somewhat as follows:

> The board of directors hereby authorizes the issuance of 20,000 shares of the authorized and unissued stock of the par value of $100 a share, of this corporation. Notice of the right, on this issuance of additional stock, to subscribe at par of $100 a share in the proportion of one share for every five shares held, shall be mailed to holders of stock of record at the close of business June 30, 1935, and therewith, or as soon thereafter as may be, assignable warrants evidencing the respective subscription rights. No subscription shall be received for less than a full share, but fractional warrants may be combined to make one or more whole shares. All subscriptions and full payment thereon must be made on or before 12 o'clock noon the 15th of August, 1935. If a subscription and payment be not made on or before that date the right to subscribe shall

thereupon terminate, and the board of directors may sell and issue such unsubscribed stock for the account of the corporation at not less than par. Stock subscribed and paid for will be issued as of August 15, 1935, and will be entitled to share in dividends declared after that date.

Often provision is made for instalment paying. And the plan may vary in other respects. But this simple resolution presents enough to follow through the essential nature of the transaction.

Attention is called to the clause stating that the board of directors may sell and issue unsubscribed stock for the account of the corporation. If the stockholder would preserve his values he must himself subscribe and make payment, or, as we shall see, must himself sell to someone else his right to subscribe. On sale by the corporation of the unsubscribed stock at the best price possible any premium obtained enures to the equal benefit of all stockholders, and the non-subscribing stockholder has lost all the value his fellow stockholders have gained.

If a stockholder, however, has no funds available to subscribe, or does not wish to exercise his right, the transaction contemplates that he will be able to make himself substantially whole by a sale of his right to someone else. This right is made completely and effectively severable from his other rights as a stockholder. So the resolution expressly provides that the warrants to be delivered to the stockholders evidencing their rights shall be assignable. The degree of probability that he will in fact be able to sell his rights, at a price sufficient substantially to preserve his values, depends on the activity of the market in the shares of the corporation. To the extent that he does not exercise his rights, and does not sell them to others, he suffers a loss in computed value which enures to the benefit of other stockholders, old and new.

EFFECT OF SALE OF UNSUBSCRIBED SHARES AT LESS THAN VALUE COMPUTED ON SUBSCRIPTION OF ALL ADDITIONAL STOCK

Assume that of 20,000 shares offered to stockholders they subscribe for only 10,000 shares, and that subsequently the directors can sell the other 10,000 shares for only $130 a share. In practice the rights would be exercised under these circumstances. The figures are presented only to illustrate a principle. The transaction works out this way:

Market value per share before issuance of additional stock	\$150
Market appraisal of capital and surplus before issuance of additional stock	\$15,000,000
10,000 shares subscribed at \$100 a share	\$1,000,000
10,000 shares sold at \$130 a share	\$1,300,000
Computed value of capital and surplus after issuance of additional stock	\$17,300,000
Number of shares outstanding after issuance of additional stock	120,000
Computed value per share after issuance of all additional stock	\$144.16⅔

So it appears that the holders of 50,000 shares, the number who have failed to exercise their rights, have suffered a computed diminution in value per share of the difference between \$150 and \$144.16⅔, or a loss of \$5.83⅓ a share, and that those who have purchased the unsubscribed stock at \$130 a share and those who have exercised their subscription rights at \$100 a share have gained this amount in computed value, as follows:

Loss at \$5.83⅓ a share on 50,000 shares of those who do not exercise their subscription rights	\$291,666.66⅔
Gain on 10,000 shares subscribed by those who exercise their rights at \$100 a share, the computed value after increase being \$144.16⅔ a share on 10,000 shares	\$441,666.66⅔
Net gain in computed value enuring to the benefit of those who exercise their rights	\$150,000.00
Value of 10,000 shares of computed worth of \$144.16⅔ a share purchased at \$130 a share	\$1,441,666.66⅔
Cost of 10,000 shares at \$130 a share	\$1,300,000.00

Computed value above cost enuring to the benefit of those who purchase at $130 a share	$141,666.66⅔
Add net gain in computed value enuring to benefit of those who exercise rights	$150,000.00
Loss to non-subscribers and gain to others	$291,666.66⅔

More probable figures would arise out of a situation in which stock is selling in the market at, say, 105, and an additional issuance is voted, to which the stockholders have the right to subscribe at 100. The directors procure an underwriting of the issue by bankers whereby the bankers agree, for a commission of $5 a share on the entire issue, to take up all stock not subscribed by the stockholders. They subscribe to 10,000 shares of the offered 20,000, and the bankers take up 10,000 shares at 100 and receive their compensation as insurers of the issue in the sum of $100,000. Corporate assets have increased by only $1,900,000 and shares have increased by 20,000. Assume, as before, that the increase is from a former 100,000 shares to a present 120,000. On such a state of fact the loss in computed value to the non-subscribing stockholder is $1.66⅔ a share. We will consider the underwriting transaction more at length later.

WARRANTS EVIDENCING RIGHTS

Notice of the resolution giving rise to the stockholders' rights will be sent out to the list of stockholders as it appears at the time of the adoption of the resolution. Until June 29 the shares sell "with rights." That is, a purchaser on the 28th will get delivery on the 30th, in time to transfer the stock into his name and receive warrants evidencing a right to subscribe. Since we are assuming an issue listed on the stock exchange, his opportunity will not exist on the 29th. Delivery of certificates on contracts of sale made on that day will not take place till July 1. The stockholders' list of rights is made up at the end of the business day on June 30.

On the adoption of the directors' resolution the preparation of warrant forms can be gone ahead with. These forms will be somewhat as follows:

No.

For subscription for shares (at the rate of one share for each five shares of common held)

UTILITY MANUFACTURING CORPORATION

A corporation of the State of Delaware

This certifies that ______________________________
or assigns is entitled to subscribe for ____ full paid and non-assessable shares of the par value of one hundred dollars each of the common capital stock of Utility Manufacturing Corporation, a corporation of the State of Delaware, at the price of one hundred dollars a share on or before the 15th day of August, 1935, at 12 o'clock noon. Payment shall be made in full upon subscription. All stock subscribed and paid will be issued as of August 15, 1935, and will be entitled to all dividends declared after that date. Subscription may be made only by executing the form therefor on the back hereof and delivery of this warrant to State Trust Company, 469 Wall Street, New York City, New York, with payment in full on the said subscription to the order of the said trust company. If subscription and payment are not so made on or before August 15, 1935, the subscription right evidenced by this warrant will terminate and this warrant be void. This warrant is transferable and divisible at the office of the said State Trust Company by the registered holder hereof in person or by duly authorized attorney, upon surrender hereof properly endorsed.

Dated, June 30, 1935

UTILITY MANUFACTURING CORPORATION

By STATE TRUST COMPANY

By

Secretary

Form of assignment and power of attorney to transfer, as on a stock certificate, and a form for entering a subscription are printed on the back of the warrant. A printed statement, further explaining the transaction, and the procedure for the stockholder to follow, is mailed with the warrant.

One set of warrant forms is prepared for rights to subscribe to one or more full shares and another set for fractional rights. For example, if John Jones is the holder of twenty-eight shares of stock he will receive a full share warrant evidencing the right to subscribe to four shares and a fractional warrant evidencing three-fifths of a right to subscribe to a share, i.e., the rights ac-

cruing to the number of shares beyond the multiple of five. He can either purchase a fractional right to subscribe to two-fifths of a share, completing, with the fraction he already has, the rights necessary for an actual subscription, or he can sell his warrant for three-fifths of a share to someone who wants to round out rights to a full share.

EFFECT OF ANNOUNCEMENT OF RIGHTS ON MARKET FOR STOCK WITH RIGHTS

Announcement of forthcoming rights affects the market price of the stock. Perhaps it is a fair generalization to say that it is taken as a bull argument in a bull market and a bear argument in a bear market. In a bull market the rank and file of speculators greet the declaration of rights as cutting a melon. In a bear market they see the burden of providing additional capital. There may be some core of reason in this: in boom times the additional capital may be a potentiality of an enhancement of profits to greater percentages on the investment; in depression periods it may be only a means of rescue from an embarrassing financial position, and the appeal to the stockholders a confession by the managers of the difficulties of the enterprise.

If the additional funds are to provide the means for an extension of business that is believed likely to enhance profits, it is entirely reasonable that the market price of the stock should in some measure discount this anticipated increase in the rate of profit. Ordinary speculators, however, are likely to regard it as they would an increase in cash dividends.

Readily marketable rights look so much like actual cash placed in hand that they seem essentially the same thing. But an increase in cash dividends indicates, or ought to indicate, an expression of opinion by the management that the enterprise has attained a position where either the profits are greater or it can afford to distribute a greater proportion of the profits. A declaration of stockholders' rights, however, is not a paying out of cash by the corporation, but a request for cash.

MARKET PRICE OF RIGHTS

Whether, after the declaration, the stock go up or down in the market, while it sells with rights the market value of the right will be based on the price per share on and after the day the

stock goes "ex-rights"; if at the close of the market on the 28th, the stock sold at 150, it should open on the 29th at 141$\frac{5}{8}$ (the $\frac{1}{8}$th nearest the computed value of 141.66$\frac{2}{3}$); and the market for the rights might be approximately from 8 to 8$\frac{1}{4}$.

It will be noted that the quotation is for the right accruing to one share of stock. Though the warrants are in terms of the right to subscribe to a share, and the fractions express the right attaching to the ownership of less than the unit of shares (five in our illustration) required to subscribe for an additional share, the market actually deals in terms of the fractions, and speaks of the unit fraction as the right.

ARBITRAGE IN RIGHTS

Presumably the rights will sell at something less than their computed value. There would be no advantage in doing the work of assembling them, and of taking the risk of a decline in the market price of the stock while the rights are being assembled, at a cost as great as that of the market price of the stock itself. Some market would arise on the dealing of those who were matching up fractional warrants. But a further market for those who wish to realize on their rights, rather than furnish the funds to subscribe to additional shares, arises out of an arbitraging on differences between the market price of the rights and their value in subscribing for stock.

UNDERWRITING ADDITIONAL ISSUANCE

In the illustration presented of rights having a computed value of \$8.66$\frac{2}{3}$, presumably all the proposed increase in outstanding stock will be subscribed by existing stockholders and purchasers of rights. In this way the values of the existing stockholders will be preserved to them, and there will not be any loss or gain to anyone. If the rights were less valuable, however, it might not be the case that they would all be exercised and the entire additional issue of stock be subscribed.

Directors want assurance that the additional funds required will be provided, and they want, or should want, to protect their stockholders, or any part of them, against loss. The directors could not make an unconditional sale of the stock to dealers in securities. Preëmptive rights of stockholders prevent this. Stock-

holders must have their opportunity to subscribe up to the full pro rata of their holdings. If they fully exercise their rights, no shares will be left to sell. Until the stockholders are precluded from further subscription by expiration of the reasonable time limit set, the directors cannot tell how much stock they will have to sell.

So they may contract with investment bankers to underwrite the additional issuance of stock. The bankers agree to take up, i.e., purchase and pay for, any shares for which the stockholders fail to subscribe. Such a contract is a true "underwriting." As we shall see, the word is applied also to unconditional agreements of bankers to purchase an issue of bonds. Strictly, an absolute agreement to buy is not an insurance, or underwriting. Common acceptance sustains the broader use of the term, and the extension of meaning does no harm. The difference between the two situations clearly appears in the agreements themselves.

Terms of an underwriting of a stock issue might be that the issuing corporation agrees to pay the bankers a commission (i.e., "premium" in insurance terminology) of two points (two per cent on par of $100 a share) on the entire amount of stock to be issued, and three points additional on all stock which they may be required to take up and pay for at par. If the stockholders fail to subscribe for any of the shares, the bankers would have to take up the entire issue. They would then be entitled to a commission of five points on the entire issue.

Since the stockholders failed to take up any of the shares at par, presumably the bankers would not be able to market them at par. But if the bankers offer the stock at 97, and succeed in selling it at that price, they would still have two per cent to cover expenses and possibly leave a profit. If, on the other hand, the stockholders should subscribe for the entire issue, the bankers would have their two per cent on the entire issue, clear profit for their risk.

Obviously this banker's underwriting commission might be used, and presumably sometimes has been used, to enable the marketing at less than par of stock that could not be sold at par. If that were the essential purpose of the directors in procuring the underwriting, one may presume, as we have earlier indicated, that the transaction would not be legal. An underwriting commission of fifteen per cent and subsequent sale by the bankers at 89 would arouse a strong suspicion of the good faith of the trans-

action. We have here our old question: What facts constitute stock watering?

In regular course the bankers syndicate the underwriting, that is, procure associates in the business, and in that way distribute the risk. The process corresponds to the reinsurance by insurers of other types of risk. We will, however, defer considering the formation and operation of syndicates for later discussion.

BOND ISSUE SUBSCRIPTION PRIVILEGES

Corporate directors may find a market among their own stockholders for bonds as well as for stock. Though stockholders do not have any preëmptive right to purchase creditor securities of their corporation, the directors may give the stockholders a preferential opportunity to buy an issue of bonds. Since a pro rata subscription to shares is a right of the members of the corporate group, notice to them of an additional issuance should refer to the offering by the word "right." An offering of bonds to the stockholders may be denominated more appropriately a "privilege."

Once the offer is made, however, it becomes a right of the individual stockholder. The privilege may not be granted to one and denied to another. And the Street is likely to call it a right. Presumably the price at which the bonds are offered will be less than their market value. The directors aim at a cost of marketing lower than they would have to pay in terms of the price bankers would make on the purchase of the issue.

Such an endeavor will be successful only if the stockholders take up the security. If, on an offering to them, they do not take up all or most of the bonds, bankers asked to purchase those remaining face an existing unorganized market in the issue. Failure of the offering to the stockholders is likely to depress the market price. In view of the difficulty of disposing of unsold bonds, bankers asked to buy them will name a price lower than they would have named for the entire issue before the offering to the stockholders. Or, if the directors procure an underwriting of the issue before offering it to the stockholders, the commission the bankers require increases as the probability of success in the offering to stockholders decreases.

Assume that the bonds would have a market value of 100, and stockholders are given the privilege of purchasing at 80. The

offering affects the value of the stock. Discount reduces effective surplus. But we do not have to take that into account in computing the market value of the privilege. On a privilege of subscribing at 80 for one $1000 bond (which has a market value of par) for each five shares of stock the computed market value of the privilege (per share) is four dollars. Any effect of the transaction on the value of the shares lies outside the market value of the privilege.

The transaction is carried through, just as in the case of stock, by the issuance of warrants.

With a large issue of the kind in which active markets are made, the creation and disposition of stockholders' rights operate smoothly and with no hardship. Those who do not wish to exercise their rights can sell them at a price substantially adequate to prevent loss. In the small corporation they may create hardship. Since there is no active market for the stock on which to base a value for the rights, and consequently no active market for the rights, a stockholder may suffer loss through not utilizing his rights at all, or through the labor of finding a purchaser and a price lower than it would be if there were an active market. Yet the offering of rights is unavoidable in any additional stock issue.

On an issue of any inactive type of security the stockholders should be protected, if possible by an underwriting. In the illustration which has been presented the underwriters agreed to take up at par any shares the stockholders did not subscribe. If the issue is one enjoying an active market, and the stock sells at a high premium, presumably the stockholders will subscribe for the entire amount offered and an underwriting may not be considered necessary. If there is an underwriting, the price at which the bankers are to take up unsubscribed shares will be in relation to the market value of the stock. The fact that the stockholders have a right to subscribe at par creates no difficulty in making the terms of the bankers' underwriting at $138.

SALE BY UNDERWRITERS

Underwriting bankers might make an offering to the investment public at large simultaneously with the offering by the corporation to its shareholders, or after that, but before the termination of the period for which the right exists. In such a case, however, the offering by the bankers would have to be subject to

allotment. That is, the bankers could not make a firm contract to deliver the stock, because they do not know how much stock will be available to them for delivery until the expiration of the stockholders' right to subscribe.

There would be some advantage in making such an offering. If the bankers wait until the expiration of the subscription rights, the investing public knows that the offering to stockholders has not been entirely successful, and the situation dampens the investment disposition towards the issue of those outside the stockholder group. On the other hand, American investors do not like to be bound to take up securities which they do not know will actually be delivered to them; and the longer the period of uncertainty, the more they dislike it.

RIGHTS TO NO PAR VALUE SHARES

Illustrations presented have referred to the creation of rights in par value stock. Marketing of no par value shares to members of the stockholder group through their preëmptive rights involves no essential difference. In fact, the situation is simpler to the extent that it is not necessary to have a market price for the stock at or above the minimum of the par value in order to effect a sale (except to the extent that underwriters' commissions may be utilized to circumvent the prohibition of stock watering in the case of par value shares). For example assume that the capital stock of the corporation is $2,000,000, represented by 20,000 shares of no par value. The capital stock per share is $100. But the directors issuing additional shares are not limited to a price not less than $100 a share. If the stock is selling in the market at $65 a share, the directors may give value to the right to subscribe by fixing the subscription price at $50 a share. Computation of the value of the rights rests simply on the relation of the offering price to the market price just as in the case of par value shares. Assume an offer of a right to subscribe at 50 to no par shares in the ratio of one additional share for each two shares held, and that the market price before the stock becomes "ex-rights" is 65. Then:

Market value of two shares at price of 65	$130.00
Cash paid for one subscribed share	$50.00

Computed value of shares after additional issue	$60.00
Cost of additional share	$50.00
Computed value of right accruing to each share before additional issue	$5.00

The operation of stockholders' rights is one of the interesting developments of mechanisms for the carrying on of enterprise through group ownership.

If an issue of stock enjoys a quick, close market, the creation of preëmptive rights works smoothly, and is an effective way of providing additional capital for those enterprises with stock selling on such terms that the rights have substantial value. In the case of the smaller corporations, the shares of which do not enjoy an active market, the rights may be something of a hardship on those who are unable to subscribe. However, it seems desirable to preserve the principle. Perhaps it would be desirable to do away with the exception to it of shares issued for property.

CHAPTER XXVII

Investment Banking Houses

Investment is still at an ebb. Will the tide ever come in again? And if it does, will it reach the old heights? Will it, perchance, rise far above them? Huge financing now takes place. But the Federal Government grants the credits, and creates a call on private ownership and income through the taxing power. Since the credits are largely for current consumption, a huge capital loss is taking place through depreciation. The equities of private owners decrease rather than increase. Will ultimate capital scarcity result in a shifting of the incidence of taxation and increase the wage of existing capital? Dealers in securities still do some business in the marketing of municipal bonds. Except for small speculative thrusts in the brewing and distilling business revived by the repeal of the Eighteenth Amendment, private corporate enterprise for several years has added not at all to its investment, and engages in capital account financing only for the purpose of refunding.

Yet outside of the huge Federal issues, which in large part the nominally commercial banks absorb, such securities distribution as there is finds its markets through the old channels. The Federal Securities Act of 1933 is in effect, and adds a new process to the marketing operation. Probably other modifications of the old forms will take place. But assuming a substantial continuance of private property, the mechanisms of the corporate form and the investment process presumably will continue. So we will examine the methods which have developed for the marketing of securities. It is through them that those who have control over wealth, all the way from the small wage earner to the rich, make such commitments to the capital fund of society as they elect. We have noticed briefly the work of the investment bankers in underwriting the additional issuance of corporate stock. Though in this operation they function as insurers, the result is that if

the risk falls in, i.e., if the stockholders do not subscribe all the shares, the bankers are obliged to buy securities which they will have on their hands to sell. It should be remarked, however, that the bankers did not become merchants of securities as a consequence of being insurers, but they became insurers because they were merchants and could market securities.

INVESTMENT BANKERS AND COMMERCIAL BANKING

The word "banker," even with the qualifying adjective "investment" turning it into the phrase "investment banker," carries an ambiguity. Primarily we use the unqualified word "banker" to describe a man who carries on the work which we describe as "commercial banking," to differentiate from investment banking.

A commercial banker borrows on demand or on short time and lends likewise on demand or short time. The word "borrows" correctly describes the business which we commonly call receiving deposits. He makes his earnings or profit through the differential between the price he pays for his borrowings and the price he receives for his lendings. Instead of saying here earnings *or* profit we might better say earnings *and* profit; for it might be well if we reserved the word "earnings" to describe the payment for the labor of rendering a service, and the word "profit" to describe the payment received for assuming a risk.

On the other hand, when an investment banker lends, he does not continue his creditor position by contemporaneous borrowing on his own account. He does not engage in the business of making a differential between the interest he receives and the interest he pays. He *sells* the loan he has made. When we visualize the business in the form it takes of the paper evidencing the rights of the creditor, we see clearly the nature of the transaction. He buys the bonds and sells them. He makes a profit. He first assumes a risk, that of a lender, then shifts the risk by sale. He buys the bonds at a price, and hopes to sell them at an advance. More often than not he does sell them at a higher price. Otherwise he could not continue in business. His total reward is part profit for the assumption of the risk, part earnings for the labor performed. It should be noted that he borrows from the commercial banker to make his loan to the enterpriser.

Stating the situation another way, we might say that the com-

mercial banker deals in short term credits and the investment banker in long term. But we shall be likely to keep the distinction between the two more clearly in mind if we consider the commercial banker as a dealer in short term credit, and the investment banker as a merchant of long term securities. The dealer in securities who renders a service without taking a market risk, we call a broker. But the custom of stock exchange brokers of making loans on the collateral of the securities they purchase for customers, margin transactions, shows them engaged in the business of assuming risks as well as of rendering a service. So functions merge into each other in types of business.

In London the investment banker is classified occupationally as a merchant. In the United States the term "investment banker" is well enough understood, and constantly used. We have no other adequately differentiating term. The phrase "dealer in securities," more shortly "dealer" when appearing in an explanatory context, is broader, and includes brokers who deal "for the account and risk" of others, as well as investment bankers who deal "for their own account and risk." Usually this last pleonastic phrase shortens to "for their own account."

CAPITAL ACCUMULATION

Investment bankers are the conduit through which the savings of those who do not exercise their entire control over wealth for present consumption become the large bodies of capital necessary for production in the forms into which the productive process has developed.

Such savings accumulate through the premiums paid to insurance companies, especially life insurance companies, deposits in savings banks and similar savings institutions, and in other individual bank accounts. The investment banker receives them from all of those sources and commits them to public loans and private enterprise. If the public loan is for the purposes of enduring improvement, it represents essentially a capital accumulation, though it may not be so in the strict sense of entering directly into a productive use.

Efficient production requires capital, tools used in the process; and social utilization of invention has come to require capital in large masses. Any society must develop a means of capital accumulation. Social organization based on the private ownership

of property provides capital through voluntary abstention of individuals, directly or indirectly, from current consumption. We have to inject some limiting phrase, as here by the words "directly or indirectly," to cover such situations as that of a corporation building up a surplus out of earnings which it does not distribute to stockholders. The refraining of some stockholders from consumption may not be immediately voluntary on their part.

Investment bankers solicit these savings for commitment to risks to which the bankers have previously engaged themselves. Dealing "on their own account," they have assumed the risk, and they pass it on to the saver, who thus becomes an investor. The banker constantly endeavors, like any merchant of goods, to carry the risk for as short a time as possible. He transacts business in a commodity of very complex character, in risks, the evaluation of which is extremely difficult. But before going further with a discussion of the function of investment bankers, let us consider their method of doing business.

PARTNERSHIPS OR CORPORATIONS

In type of organization they have until recent years carried on their work as individuals or, more commonly, as partnerships. It was felt that an unlimited liability expressed a sense of integrity better than the limited liability of the corporate form. During the past two or three decades, however, the corporate form has become more frequent in the business. The development, by commercial banks, of affiliated investment banking corporations, now under Federal prohibition, helped make investors familiar with the corporate form of investment business.

An investment banker is not a guarantor of the securities he sells; and once he has sold them he is out of the risk, except that he is responsible for the representations he has made in selling. This exception is a large matter. And often investors transmit to the banker funds in payment for securities which the banker delivers after he has received the funds. A feeling of confidence enabling this to be done greatly facilitates the transaction of business. Other than in these respects an unlimited liability is of no special consequence to the investor.

Yet it has seemed to some observers that through the recent decades, during which the tendency to incorporate has developed,

some investment bankers have shown less sense of responsibility than formerly was felt by most of those engaged in the business. To some extent the incorporation may be a result of a lower morale. Probably most of it, however, has been simply a matter of convenience in form of organization. The word "house" has become attached to the business. Whether the investment banker is an individual, a partnership, or a corporation, we speak of an investment banking house.

ORIGINATING AND DISTRIBUTING — CAPITAL REQUIRED

Considering the magnitude of the transactions engaged in, the business does not require large capital. But the amount needed depends on the type of business done. The business divides into what is called originating and what is called distributing. Originating houses make the commitments to purchase securities from the issuer — private corporation, municipality, State, or government — for which funds are being provided. Distributing houses make the sales to investors. Most originating houses also distribute. Many distributing houses do not originate. Their relationship will become clearer in the course of a consideration later of the process of syndicating securities.

Originating houses require a capital large enough to enable them to provide an equity in the purchase of securities to which they become committed. Though in normal course these houses can procure a bank loan for most of the funds necessary to make the purchase, the bank, to protect its loan, usually will demand that the investment banker supply some substantial amount in effecting the transaction.

The size of this equity varies much with the type of security involved. A high grade State or municipal issue would ordinarily require the least; an active market, high or good grade private corporation security, more; a private corporation security of a kind not having an active market, most. In actual practice, the originating houses largely finance the distinctively distributing houses, through providing the bank loans with which an issue is carried during the process of marketing.

With the carrying provided by the originating houses in this way, the distributing houses do not need so much capital as they would otherwise require. Under the forms which the business has developed, they can refrain from large liability in the pur-

chase of security, and sell in accordance with their ability. To the extent to which they do not assume the risks, however, but confine themselves to the work of selling, they will have to be content to forego the profits which may arise out of the risk, and be satisfied with the payment for service performed. The manner in which the separate compensations are provided will appear in the discussion of syndicates.

Except for such liabilities as the distributing house may assume, it needs capital only for clearance. That is, the investor purchasing from it will ordinarily not expect to make payment until the delivery of the security, or at least will expect the security to be delivered very promptly after payment. The distributor will need to be able to forward to the originator sufficient funds to procure the release of so much of the security from the collateral for the bank loan.

SPECIALIZING

Investment banking houses may further differ from each other in the types of security they handle. One may deal primarily in municipal bonds, another in those of public utility corporations, a third in industrial securities. Such specialization has the advantage of the possible development of greater knowledge and better judgment of risks involved in the particular field. For a really adequate estimate of risk, the investment banker needs to know as much about the nature of a business as its own management knows.

Like any merchandising, the business of investment banking involves the two sides of buying and selling. For those houses which do not originate, the buying problem is of the simplest. The originator has carried through the work of buying; the non-originating distributor comes to a decision on the results of the originator's investigation. Indeed, he may not even have had the occasion to give much consideration to those results. Business expediency of assuring a continued supply of securities to sell may make it desirable for him to participate in any issue the originator may bring forward, and limit the discretion of the distributor to the size of his participation. This quasi compulsion has been criticized. The pressure objected to seems, to say the least, not in excess of that which automobile manufacturers are rumored to exert on distributors.

BUYING SECURITIES

Let us consider first the process of buying securities. What establishes the contact of the issuer and the investment banker, out of which negotiations arise, resulting finally in a purchase? In the case of the public securities of the State or municipality the situation is simple. The issuer publishes notice of intention to borrow and invites competitive bids. However, we are not concerned with such financing, but with the securities of private corporations.

If the investment demand is active, and securities are relatively easy to sell, the banker may be looking for situations justifying the issuance of stock or bonds. On the other hand, if numerous enterprises seek financing at a time of inactive investment demand, the banker may make his choice of what situations he will investigate. Sometimes an enterprise has expanded its current loans to a point where it does not periodically clear them up; and the commercial banker, realizing that he is really supplying permanent working capital, which should not be in the form of current debt, but funded in capital stock or in a bond issue, advises his borrower to seek the aid of an investment banker, and supplies the introduction.

PURCHASE OF INDIVIDUAL INTEREST NOT ADDING TO ASSETS OF CORPORATION

Sometimes a man who through a lifetime has built up a large enterprise from a small beginning, and has remained its principal owner, wishes to withdraw part or all of his fortune from the undiversified hazards of a single business, and create an estate of diversified investments and diminished risks. He may find that selling such interest as he wishes to dispose of to the general investing public through investment bankers presents the convenient way of accomplishing what he desires. In that case he is individually the seller, and disposes, for his own account, of securities previously issued to him. He receives the proceeds as his property. Investment in the enterprise does not increase.

NEGOTIATIONS

For illustration of the process through which an investment banking house buys securities, let us follow through the pur-

chase, as it might take place, of any issue of industrial bonds. The president and treasurer of the corporation carrying on the industrial enterprise come to the office of the investment banking house and are discussing their proposal with two of the partners of the investment firm. The corporation, whose plant is located in the Northeast, has an opportunity to buy a competitor which has its plant in the Middle West. The directors of the Eastern enterprise believe the acquisition desirable as, among other advantages, enabling them to serve the two territories from the plant located in the territory. The terms require a substantial amount of cash. And the management of the corporation sees that if it acquires the additional business it will have to have a larger amount of working capital than it now has.

To provide the necessary funds of about $9,000,000 they propose a bond issue secured by a first mortgage on both plants. The situation, as the president and treasurer of the corporation represent it, seems amply to justify a first mortgage loan of this amount. A difficulty in giving a first mortgage on the entire property appears in the fact that the Western plant has an outstanding bond issue of $1,500,000 secured by mortgage. But these bonds are redeemable at 110, and provision for their redemption is part of the cash requirement in carrying through the transaction.

Producing balance sheets and income accounts, the president and treasurer point out that the assets to be mortgaged have a value of more than four times the amount of funds sought; and that for the two enterprises the combined earnings available for the payment of interest is more than $2,500,000, and has not been less than $2,000,000 in any of the past five years. They talk about the possibility of increasing the earnings through the economics of the combination; discuss the nature of the business, its probable future, other manufactures of the same product, and generally the possibility of profit, and the risks involved.

Favorably impressed with the situation, and in a position to take on a new piece of business, the bankers indicate that apparently the situation is such that they could sell five per cent bonds, which should presumably have a term of twenty-five years, and that for such bonds they might be able to pay about 90. Since the officers of the corporation have with them only the most recent annual financial statements, the bankers ask for such statements running back over a five-year period, and for a report

of the business for each month of the several that have elapsed since the date of the last annual statement.

After the officers of the corporation leave, the bankers seek, from other sources, information about the industry and of this particular enterprise in it. Much of what they learn corroborates the statements of the president and treasurer. Some things they learn seem more favorable, other things less. The corporation sends them the additional statements. Several of the partners of the banking house visit the plants. The president and the treasurer of the corporation return for a further conference, and bring with them the president of the concern it is proposed to buy. He desires the combination to take place, and has not made difficulties in furnishing the information the bankers want about his corporation.

CONDITIONAL COMMITMENT

Deciding to go ahead with the business, the bankers write to the corporation a formal conditional commitment letter somewhat as follows:

Utilities Manufacturing Corporation

Dear Sirs:

On the terms and conditions stated in this letter, we offer to purchase $10,000,000 in face amount of five per cent twenty-five year sinking fund bonds of Utilities Manufacturing Corporation, a corporation of the State of Delaware, at ninety per cent of the face amount thereof and accrued interest.

Prior to or upon the issuance of the said bonds, Utilities Manufacturing Corporation will have acquired all the assets of Arco Manufacturing Corporation, a corporation of the State of Illinois, having its plant at Jonesville, Illinois, and will have assumed all the liabilities of the said corporation in an amount not exceeding the amount shown in the balance sheet of the said corporation annexed hereto, and not including any liabilities for income taxes or otherwise not shown on the books of the said corporation.

The bonds are to be the entire authorized issue, and are to be secured by a first mortgage to Fidelity National Bank of New York City, trustee, or to such other bank in New York City, as trustee, as we may elect, on all the assets, except quick assets, now owned or which may hereafter be acquired, by Utilities Manufacturing Corporation, especially including the assets to be acquired of Arco Manufacturing Corporation.

They are to be dated as of November 1, 1935, to bear interest at the rate of five per cent per annum payable semi-annually at the office of the trustee, and to mature twenty-five years from their date. A sinking fund shall be provided for in the trust indenture, computed on such a basis that the annual instalment of amortization of principal plus the interest payable on all bonds outstanding shall impose on the corporation an equal annual charge. The sinking fund shall be applied to the purchase of bonds by call or by the purchase in the market at less than the call price. The corporation is to have the right to exceed its sinking fund requirements in any year or years and the credit of any excess against the sinking fund obligation in any subsequent year or years. All bonds acquired for the sinking fund shall remain a charge against the corporation until all outstanding bonds shall have been paid or so acquired: The bonds shall be subject to redemption as a whole or in any part at the option of the corporation, and to call by the trustee for the sinking fund, on any interest payment date, on thirty days notice, at 110 and accrued interest. The bonds shall be in coupon form with provision for registration as to principal, and shall be denominations of One Thousand ($1000) Dollars and Five Hundred ($500) Dollars in such proportions as we may require.

Principal and interest shall be payable at the office of the trustee in lawful money of the United States.

The mortgage shall contain a covenant of the corporation stipulating to pay principal and interest without deduction of any tax or taxes which the corporation or the trustee shall be required to pay thereon or deduct therefrom under any present or future law of the United States of America, or of any State, County or Municipality therein (other than income or profits, taxes, exceeding in the aggregate two per cent per annum, and decedent estate and inheritance taxes).

The corporation will make an agreement with us that it will use not to exceed $4,500,000 of the proceeds of the bonds to pay, or reimburse itself for the payment of the cost to it of acquiring the assets of Arco Manufacturing Corporation, including the redemption of $1,500,000 of bonds secured by mortgage in the said assets.

Our undertaking to purchase such bonds is subject to the following conditions:

Opinion of counsel designated by us, addressed to the trustee, and to us, that Utilities Manufacturing Corporation has good title to all the assets mortgaged by it to the trustee to secure said bonds.

That your representations of assets, liabilities and earnings of Utilities Manufacturing Corporation and of Arco Manufacturing Corporation are verified as to plant and other tangible assets by Federal Appraisal

Company of New York City or such other appraiser as we may designate, and as to earnings and intangible assets by Smith, Hobson & Company of New York City, or such other accountants and auditors as we may designate, and that the accountants find that the condition of the business now carried on by the said two corporations is sound and substantially as indicated in the said representations. If such examination does not verify the representations made, the sole effect shall be that we shall be under no obligation to proceed with the purchase of the said bonds.

By such verification it shall appear that assets and earnings are in accord with the statements annexed hereto.

All legal matters in any way affecting the validity of the bonds and the lien of the mortgage and the terms thereof as giving effect to the conditions of this offer shall be subject to the approval of counsel designated by us, who shall find that the bonds are valid obligations of the corporation and secured on all of its assets as herein provided. The mortgage and trust indenture shall contain all usual covenants for the protection of the bondholder and the trustee.

Your board of directors and officers will seek all necessary authority from stockholders. However, neither the directors nor you shall be liable for failure of such authority, but, nevertheless, you will pay all expenses incurred by us stipulated herein to be paid by you.

Our engineer or engineers shall examine the plant. Every reasonable facility for the examination of all matters of interest shall be afforded to our attorneys, auditors, appraisers and engineers, and they shall have access to all the books and records of the company and to all parts of the plant.

All expenses of such examination of plants, accounts, inventories, title, and all other legal matters, though incurred by and for us, shall be paid by Utilities Manufacturing Corporation, whether or not the representations are verified and whether or not our counsel find the bonds can be legally issued and security given. And it shall also pay all costs of printing or engraving temporary or definitive bonds, which shall be prepared to satisfy the listing requirements of the New York Stock Exchange, of printing and recording the mortgage and trust indenture, and documentary stamps required for bond issuance.

You will comply with all requirements, including the furnishing of all information and making and verifying all statements, of the Federal Government and its administrative agencies for the registration of the bonds, and likewise, at our request, of any State government and its agencies for qualifying the bonds under any State security act or Blue Sky Law. Failure to procure the registration of the issue by the Federal Government and their qualification by each and every of the States of

Massachusetts, New York, New Jersey, Pennsylvania, Michigan, Ohio, Illinois, shall release us from any obligation to purchase the bonds.

You will likewise comply with all requirements of the New York Stock Exchange for listing the bonds, will make application therefor, and pay the cost thereof. Whether or not application for listing is made, or the issue is listed, you will furnish us and publish full annual financial statements complying with the requirements of the Code of Fair Competition for Investment Bankers which are set forth in a statement annexed hereto.

We are to begin our investigations to verify representations, and other matters herein referred to, promptly on the acceptance of this offer, and to press them with proper diligence. On verification of the representations, the validity of the bonds, and the lien of the mortgage, we will take delivery of the bonds and make payment therefor at the office of the trustee in New York City, as soon as the temporary or definitive bonds issuable under the proposed mortgage and trust indenture, preparation of which bonds shall be ordered by us and to be under our supervision, shall be ready for delivery.

Very truly yours,

ROBINSON, BROWN & COMPANY,
by Everett Brown
(One of the partners in the said firm.)

Accepted:
UTILITY MANUFACTURING CORPORATION
by Henry Smith, President, hereunto
authorized by the Board of Directors

SOUNDING OUT ASSOCIATES

While the negotiations leading up to the conditional commitment have been going on, the bankers have been sounding out the banking houses who are their usual associates in bringing out an issue, and have found them favorable to the business proposed, believing that the security is sound and can be sold at a profit on the terms indicated. This attitude of the other banking houses has been an important influence in determining the decision of Robinson, Brown & Company to go forward with the business. They would not care to undertake the risk and labor of marketing the issue alone.

INVESTIGATIONS OF EXPERTS

On the signing and delivery of the commitment, the bankers definitely engage their experts for the necessary investigations.

Legal counsel have already been working with the bankers to some extent in the negotiations and the preparation of the commitment letter. Now appraisers and auditors send out their crews to the plants and offices of the corporations involved. It will probably take a month or more for them to complete their investigations and make their reports.

It is seen that, of the personnel of the banking house, hardly anyone but the partners themselves enters into this work of buying securities. They employ outside experts for the laborious work of investigation. They cannot market enough issues in a year to keep a staff of experts of their own constantly employed. There are periods during which very little investing is done. The market closes up. They cannot afford to carry the constant overhead of expensive employees. Outside firms can shift to jobs for other banking houses, and in periods in which there is little market for securities can perhaps busy themselves with the other types of work they do. The risk of employment is on them.

RESPONSIBILITY OF EXPERTS

Even if the bankers could afford to maintain engineering and accounting divisions in their own offices, they would not. For this work, they employ investigating concerns of such prestige that the names carry influence with investors. Since these concerns are not dependent on the one employer, they are not under the same pressure to color their reports to meet the wishes of the banking house as employees on its own pay roll would be. The firm of experts outside the bankers' organization wishes to maintain with the investing public the prestige which gives a special value to its reports. It has a moral responsibility to investors.

Under the Federal Securities Act of 1933 the expert has a legal responsibility. It requires the filing with the Federal authorities and furnishing the investor with an extensive disclosure of facts called the registration statement. Section 11 of the act provides:

> In case any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, any person acquiring such security (unless it is proved that at the time of such acquisition he knew of such untruth or omission) may, either at law or in equity, in any court of competent jurisdiction, sue *** every accountant, engineer, or appraiser, or

any person whose profession gives authority to a statement made by him, who has with his consent been named as having prepared or certified any part of the registration statement, or as having prepared or certified any report or valuation which is used in connection with the registration statement, with respect to the statement in such registration statement, report, or valuation which purports to have been prepared or certified by him.

And this, as we shall see further, when we come to consider the topic of government regulation of the sale of securities, is irrespective of whether the investor relied on, or even knew of, the incorrect statement; except as, by an amendment to the act, the expert has the rather cold comfort that:

If such person acquired the security after the issuer has made generally available to its security holders an earning statement covering a period of at least twelve months beginning after the effective date of the registration statement, then the right of recovery under this subsection shall be conditioned on proof that such person acquired the security relying upon such untrue statement in the registration statement or relying upon the registration statement and not knowing of such omission, but such reliance may be established without proof of the reading of the registration statement by such person.

CHAPTER XXVIII

Purchase of Securities: The Closing

REPRESENTATIONS CONFIRMED

Experts make no mere casual examinations. Lawyers trace back the titles of the various parcels of real estate the corporation acquired for its plants. They delve into the public records for judgment, tax, and other liens. Investigating the corporate records, they ascertain that the enterprise was validly incorporated. They may require the secretary to certify parts of the record so that their files will show the information on which they have relied.

Appraisers see and value each item of tangible assets. Usually the members of the firms doing this kind of work have the training of engineers. For the values of the real estate they may in turn take the opinion of local real estate men. Otherwise, for buildings, machinery, tools, equipment, and inventory, the appraisal crew examine everything, and enter in their report an inventory and appraisal to the extent of a large volume. They base their estimates on cost of replacement less depreciation, which are going concern values.

Accountants audit the books over the required number of years, and adjust the corporate annual statements in accordance with the findings of the audit. They investigate the receivables, and generally do whatever accountants can do to ascertain the facts of the business.

While all this goes on, counsel for the bankers, working with counsel for the corporation, and, to the extent that the situation may require, with counsel for the bank which is to be trustee of the mortgage, see that the necessary corporate action is under way to authorize the bonds and mortgage securing them. Stockholders must approve the giving of a mortgage and authorize the indebtedness it secures.

Directors must adopt correlative resolutions. The board may

have authorized the commitment to the bankers before action of the stockholders. Time passes and chances must be taken. They have protected themselves by the provision in the commitment against damages. When the early investigation by counsel for the bankers, and the preliminary reports of auditors and appraisers, indicate that the experts are likely to verify the representations of the corporation, counsel may begin drafting the mortgage and trust indenture.

THE CLOSING

Counsel for the banking house draw the mortgage indenture, and submit it to counsel of the corporation, and to counsel of the trustee, for approval. The commitment letter indicates the general outline which the mortgage completes and fills in. Counsel's draft goes to the printer, who furnishes extra copies of the proof for transmission to the respective counsel for the corporation and the trustee, who do not see the proposed instrument until it is in this proof form. They may suggest changes which may or may not give rise to arguments. A revision may go to the printers for revised proof to be resubmitted; and so on until all parties are agreed, and final proof goes to press.

Since application will be made to the stock exchange to list this $10,000,000 issue, and the exchange requires engraved bonds, the preparation of which takes time, the bankers request temporary bonds so that the offering of the security for sale need not be delayed. Such temporary bonds may not have any coupons attached, because the bankers expect to have the definitive security ready for delivery before the first interest date. It is better to issue temporary bonds than to deal with the situation by the use of bankers' interim certificates undertaking to deliver the security.

With the temporary bonds the investor has the security itself. He should not be asked to part with his funds for a banker's contract. The banking houses themselves recognize the undesirability of interim paper, and provide in their Code of Fair Competition (Art. III, Sec. 10) that it is the duty of the banker "to deliver as promptly as possible after the public offering date, definitive or temporary securities of the issuer." Counsel for the several parties may agree on the bond form, so that preparation of the bonds may proceed before they have finished revision of the rest of the mortgage.

Meanwhile the bankers will be meeting their problems. They will be forming the syndicate or syndicates to distribute the risk and market the bonds. They negotiate the loan or loans necessary to enable the carrying of the bonds during the distribution. Before time of the delivery from, and payment to, the corporation, they will presumably have completed not only the purchase syndicate but also the distributing syndicate; so that when the day of payment to the corporation arrives, they will take over the bonds as managers of the distributing syndicate.

PREPARING REGISTRATION STATEMENT AND OTHER QUALIFYING PAPERS

At the same time they will have the problem of preparing the formal statements containing the representation of facts on which the bonds will be sold. This was formerly the "circular"; but now, under the Federal Securities Act, it will be the prospectus required to be furnished to all investors in the bonds. The act leaves no discretion as to the information to be given.

Extent of disclosures varied a good deal before the enactment of the statute. Bankers did not make false statements. Falsehood in positive form was too gross for the least conscientious, and exposed them to legal liability for misrepresentation. The old aphorism that "Figures don't lie, but liars will figure," however, had some application. For example, averages may conceal threatening years. But, mostly, any overfavorable appearance arose through the deft exclusion of damaging facts.

The new Federal Securities Act is full of warnings against such suppressions, as in our recent quotation from it the clause imposing a liability for omission in the registration information "to state a material fact *** necessary to make the statements therein not misleading." Though the act requires such disclosures as ought to be made, no wonder the bankers, their counsel, and other experts shuddered at its provisions. Lack of any facts may be misleading to anything less than omniscience.

It is easy for those whose economic life is not put at stake by such legislation to advocate it. Yet we may perhaps trust that the courts will interpret these requirements reasonably; and for liability to arise, require a knowledge that the omission would be misleading — or an imputation of such knowledge as men of experience in the business they are undertaking should have.

Along with the preparation of the Federal registration statement, the bankers and their counsel will have the work of preparing other statements to qualify the issue under the Blue Sky Laws of the various States in which it will be sold; and of presenting the information to the State administrative bodies; and of following them up by correspondence and personal appearance, until the necessary consents to sell are obtained. We will consider this problem in the chapters on government regulation of the sale of securities. The reader will recall the reference in the commitment letter to these statutes.

RISK OF THE MARKET

Progress in all these matters needs to be expeditious. The bankers carry a heavy risk of the market. Assume that they based their purchase price of 90 on an expectation of selling the bonds at 95. With a twenty-five year issue, the basis rate of five per cent bonds at 90 is approximately five and three-fourths per cent; and at 95, approximately five and three-eighths per cent. A little change in economic conditions may destroy the margin and turn an anticipated profit into a loss.

Bankers cannot sell until they have all the required governmental releases, or until they know that they will have valid bonds secured by mortgage to deliver. They may be able to sell a little in advance of actual delivery, but not much. Investors dislike to commit themselves to the purchase of a security greatly in advance of the conclusion of their transaction by delivery and payment. Yet, however pressingly the bankers and their counsel work, progress all along the line depends on other people; especially on the personnel of the governmental agencies who are not under the urgency of economic hazard.

CLOSING DATE

When the situation has sufficiently developed, the bankers, the officers of the corporation, and the trustee agree upon the day for the delivery of the bonds by the corporation and payment by the bankers. This event is called the "closing." Under the terms of the commitment letter, it is to take place at the office of the trustee. The executed mortgages and temporary bonds have already been assembled there, where they are held in escrow;

i.e., for the fulfilment of all conditions that must be fulfilled before unconditional delivery of the mortgage to the trustee, and of the bonds to the bankers.

We have assumed that the bankers have formed their distributing syndicate, and are the managers of it. To provide the funds to be paid to the corporation, they must have arranged for a loan to the syndicate. Let us say that the closing date is November 16. The bonds are dated as of November 1 and bear interest from that date. Payment to the corporation includes, then, fifteen days of accrued interest, which at five per cent on $10,000,000 bonds is $20,548 (computed on the basis of 365 days to the year). Since the purchase price at 90 is $9,000,000, the total sum to be due the corporation is $9,020,548. The corporation may owe the bankers for costs of investigation under the terms of the commitment letter. Whatever the amount is, it may be deducted from the sum the bankers are to pay. They must have the net amount at the closing to pay over on receiving the bonds.

Purchase by the issuing Utilities Manufacturing Corporation of the plant and business of Arco Manufacturing Corporation complicates our hypothetical transaction. We have not in any way considered the cost of this acquisition other than to see that cash proceeds of the bond issue not exceeding $4,500,000 are to be applied to this purpose. It may be that, in addition to the cash payment, the Utilities Manufacturing Corporation is also issuing stock in payment.

Any stock to be outstanding after the transaction will appear in the bankers' disclosure of facts. We will assume that some stock is being paid, but will not concern ourselves with the amount. The Arco Corporation will not transfer its property until payment is made. Furthermore, its bonds are to be redeemed, and the mortgage securing them discharged. All the cash is to come out of the proceeds of our bond issue, the terms of which require the acquisition of these assets and the discharge of this mortgage.

We have one of the situations, frequent in financing transactions, analogous to the problem of the man with the goat, dog, and cabbage to transport across a stream in a boat that will carry only the man and two of the three objects to be transported. Without the restraining presence of the man, the goat will eat the cabbage, and the dog will kill the goat. It would be desirable to have the Arco mortgage discharged, so that no reference need

be made to it in bringing out the Utilities Manufacturing Corporation issue. But it cannot be discharged without the cash, and the cash cannot be obtained until the new bonds are issued.

In spite of the disadvantage of making any mention of the Arco mortgage in the statement of the new issue, it has been decided to provide in the mortgage securing it that $1,650,000 cash proceeds of the bonds shall be held by the trustee to be paid out by it to the Arco Corporation on the redemption and cancellation of its bonds, and discharge of its mortgage; and it may be recited that the Arco Corporation has agreed with the bankers and the trustee to call the bonds for redemption. Let us assume that, aside from the cash for redemption of the Arco bonds, the purchase of the Arco assets and business requires $2,750,000 in cash.

It has been arranged that the Arco assets are to be transferred to Utilities Manufacturing Corporation at the same time its mortgage is delivered and the bonds are issued. The officers of the Arco Corporation entrusted with the business attend at the closing with the deeds, bills of sale, assignments, and any other papers necessary for them to carry out their business. Counsel for the Arco Corporation comes also.

PROCESS OF CLOSING

Officers of the Utilities Manufacturing Corporation and their counsel appear with the certificates of the stock of the corporation to be delivered in part payment for the Arco Corporation assets. These certificates are in the name of a nominee for the transaction, and are endorsed by him so as to be good delivery. The nominees might be the bankers.

One or more of the partners of the investment banking house come in; and also, from the law firm acting as their counsel, a member who has worked on the transaction throughout and is thoroughly familiar with it. The bankers have with them a portfolio containing the signed syndicate agreements; and the lawyer has the closing memorandum, which may be described as essentially the agenda for the meeting, stating the figures for each item, convenient for checking, to be sure that everything accords with the various contracts which are to be performed.

As the various people appear, they take seats around a "directors table." The officer of the trustee bank in charge of its

corporate trust department brings in the executed mortgages and the signed temporary bonds, which he places on the table in front of the chair he takes.

And finally a man indispensable to the business enters, the man who for the moment has the money, an officer of the bank making the loan to the bankers for taking up and carrying the bonds. He has with him cashier's checks made out in names and amounts in accordance with instructions which the investment bankers have previously given the bank.

Let us have an anticipatory look at these checks. One for $2,750,000 names Arco Manufacturing Corporation as payee; one for $1,650,000 is payable to the trustee, which, as we have seen, is to hold the funds for payment on the redemption and cancellation of the Arco bonds. These two checks make the aggregate of $4,400,000 cash which Utilities Manufacturing Corporation has to pay to the Arco Corporation, to clear its mortgage. A third for $4,620,548 runs directly to Utilities Manufacturing Corporation. The three checks, aggregating $9,020,548, are to pay for the $10,000,000 issue of bonds at 90 and accrued interest. At the request of Utilities Manufacturing Corporation, the bankers are paying part of the total amount to the trustee, and part to the Arco Corporation, as a convenient way of carrying through the purchase of its assets.

Each representative of the various parties to the entire transaction examines the various papers to be delivered to him to make sure they are in order before he accepts them. The partners of the investment banking house, and the representative of the bank making the loan to it, examine and count the bonds. There is not much chance for error here. On authenticating them, the trustee did them up in packages of, say, a hundred each and its representative vouches for the count.

Utilities Manufacturing Corporation inspects the deed, bill of sale, and assignment, which are to convey the assets of the Arco Corporation; and the Arco counsel examines the certificates for stock of the Utilities Manufacturing Corporation, which are to be delivered in part payment, and makes sure that they represent the right number of shares. Since counsel for the banking house have the responsibility of seeing that bonds to be delivered are secured by a mortgage on the assets of both corporations, they, as well as counsel for the issuing corporation, need to make sure that the assets of the Arco Corporation are properly conveyed.

Presumably everyone is satisfied with all the papers — that they are in the forms agreed upon, are properly executed, and will carry out the intent of the whole transaction. The Arco Corporation representative delivers his conveyances to the representative of Utilities Manufacturing Corporation, and he delivers the five counterparts of its mortgage to the officer of the trustee.

Only constructively, however, do the bonds go into the possession of the investment bankers. The officer of the bank making the loan to carry, delivers his checks; and his armed guards, who have been waiting, put the bonds into their bags and carry them off to their bank as collateral for the loan. The syndicate participation agreements, which the investment bankers deliver for additional security, go with the bonds.

Everybody delivers to everybody else the proper authorities and receipts, which were all prepared in advance, and the closing is over. The bond issue has been bought and paid for.

CHAPTER XXIX

Selling Securities

As we have seen, two or three of the partners may do most of the work done by an investment banking house itself in buying securities. It consists of entering into and continuing the relationships through which issues are offered to the house; and in formulating the investing judgment on the soundness of the proposed commitment, both from the viewpoint of profitable use of the capital, and from the viewpoint of the marketability of the securities. Other partners and employees may enter into the matter to consider it from the second viewpoint. Though the business of the issuer is such as to indicate a profitable use of the capital, still the securities may not appeal to investors under market conditions existing at the time. So the opinion of those primarily engaged in selling finally determines whether or not the purchase shall be made.

INVESTMENT BANKING A BUSINESS OF SELLING

Investment banking probably requires a much smaller proportion of its entire labor to be exerted in buying than most other merchandising businesses. It is almost entirely selling. This fact has disappointed many young men whose imagination had kindled with the large figures of investment finance, with the thought of captains of industry, and the control of economic destinies. Commercial banking also deals with large aggregate figures; yet most young men know that such laborious and undazzling detail as ledger keeping makes up the greater part of its work. But investment banking does have its fascinating background of great transactions.

We cannot foresee just what channels will develop for the flow of savings into capital aggregations. It is highly probable that in the future they will not follow the old courses throughout. We

can describe the route only as it has existed in the recent past. If private ownership continues an essential part of the economic organization of society, probably most of its ways will continue, including those of the issuance and marketing of securities.

It is to be hoped that some will change a great deal. Personal solicitation has been too urgent and extensive. Though the writer believes this statement is true throughout the field of business, he believes such canvassing especially injurious in the field of investment. Probably a housewife's purchase of an article she has no need for does not do as much harm as her husband's purchase of a security of a kind he ought not to buy.

POSSIBLE RETAIL DISPOSITION OF ENTIRE ISSUE BEFORE CLOSING THE PURCHASE

Leaving generalization for a while, let us return to the specific in the marketing of securities. Before the day of the closing we have described, the bankers have completed their syndication of the issue. Subsequent chapters will fully describe this process. It may even happen that before the closing the entire issue has been sold to investors. If the securities market is active, and the issue makes a strong appeal, it is possible for the bankers to experience such good fortune. In that case their loan to carry the bonds turns out to be only a clearance operation. Within a few days the bankers will deliver the bonds to the final buyers, the proceeds pay off the carrying loan, leaving the profit in hand to close out the syndicate transactions.

Under the terms of the syndicate agreement, the originating bankers, as managers, notify all the participants in the syndicate of the day on which they may begin to sell the bonds. The date may be a day or two before the day set for the closing. On the date of offering for sale, advertisements of the issue appear in the newspapers, and all the salesmen begin their labor on the issue.

SECURITIES SALESMEN

This brings us to the bond salesman, who for many years past has carried on the work of marketing securities. More frequently than not he comes into the business as an apprentice on graduation from college. It is (in spite of the jeers of many) an eminently respectable occupation, which enables him to appear in the eyes

of his sweetheart and social acquaintances as a Wall Street man; or, if he is not located in New York City, as engaged in "financial work." This stimulus of vanity does no harm, but may support him in persisting through a trying period to success.

He also chose to try the job because it does not involve the further expenditure of money in preparing for a profession, with its long delay of self-support and probable postponement of marriage. Besides, he is tired of school and study, and wants to be at work objectively; and the business of selling bonds contains a possibility of more rapid advance to substantial pay than many other employments.

BEGINNERS' PAY

His beginning wage depends on the phase of the economic cycle and the current price level. It will be rather nicely calculated to enable him to live without actual physical suffering, whatever his mental anguish may be for falling short of some level of conspicuous consumption. In short, it will be the pay of any apprentice under the American system, in which the employer does not seek to make an immediate profit out of his apprentices, but expects to sustain a temporary loss, in the hope that his apprentice will develop into a journeyman and stay with his employer long enough for recouping the initial loss.

PERSONAL QUALIFICATIONS

It is difficult to estimate the aptitude of a beginner for the work. Rather widely varying types succeed. The job consists of finding people who have funds to invest and establishing a business relationship. A young man who does not make a favorable appeal to one person may to another. Aside from personality, success depends on temperament. To adopt a useful enough argot, the work of salesmanship is not for introverts, but for extroverts. A salesman, for much success, must enjoy meeting people, new people. He must not too greatly care whether or not they enjoy becoming acquainted with him. Often the contemplative young man has a will power adequate for the necessary persistence in the disagreeable task, but, not enjoying it, he can have little success, if any at all. Yet the glamorous aspects of finance may have made a strong appeal to his imagination.

DIFFICULTIES OF GATHERING NUCLEUS OF CLIENTELE

Selling securities is probably the most difficult of all salesmanship — unless perhaps the selling of insurance. A bond salesman must persuade people to part with relatively large sums of money for a piece of paper as the only tangible object. He must find his prospects entirely on his own initiative. If an experienced salesman is leaving the banking house, it does not entrust to an apprentice the competitive job of keeping his clientele attached to the house; unless, indeed, his territory is a very poor one, and the clientele of no great importance. If the house supplies the apprentice with a list, it is one culled from the addressograph, and contains only the names of people with whom the house has no actual contacts, but of whom it wants to be sure they are not "prospects" before saving postage and stationery by striking them from the mailing list.

A salesman for a wholesale grocery concern knows that all retail grocers buy the kind of goods he has to sell; and that, practically, no one else buys them in the quantities he must sell. But of all the multitudes of human beings in the world, which individuals are investors, and of those who are, which ones are currently in funds for commitment? Men actively engaged in business are likely to be using all their funds in their own enterprise, and very likely straining their credit to gain advantage by the use of the funds of others. Those who live ostentatiously may be doing so to create a reputation for means they do not possess. Most of those who live modestly have not the means to live otherwise, if they would.

DISCOVERING "PROSPECTS"

If the assigned territory includes only relatively small towns and cities, the salesman can find most of his possible clients by their general reputations. In such places the affairs of people are commonly known. If he can get on a friendly basis with someone at the crossroads of gossip, he may pick up a good deal of useful information. But so can the salesman for other security houses. He finds his territory highly competitive.

In the larger cities the salesman must find "prospects" as best he can. One evening he may make up from the classified telephone directory, or other source of information, a list of those engaged in some special type of business to canvass on the next day.

On a rainy day he may make a "cold" canvass from top to bottom of one of the large office buildings. He, or the sales manager of his house, may get the idea of watching the records of the Probate or Surrogate's Courts through which decedents' estates are settled. Here is money in transit. But, alas, the vast majority of "estates" result in nothing for investment. They are mostly small affairs, and the beneficiaries have long premeditated plans for the disposition of their shares.

Besides, what shall be watched: the proceedings for probate and appointment of administrators, or the accountings? Often the fiduciaries settle the estate without an accounting. They have authority only to liquidate, not to make investments. If the salesman waits the usual year or more for the accounting, he may find that substantial distributions have taken place long since and the beneficiaries have already disposed of the proceeds.

Nevertheless, in one way or another the persistence of the bond salesman finds prospects; and such abilities as he has develops some of them into clients. Sometimes the apprentice has a stroke of luck and sells a bond or two within a comparatively short time after beginning his endeavors. This success pricks up his courage and urges him on. But for six months at least sales are not likely to be frequent enough to make that continuity which might be described as a trickle. Though an occasional sale greatly encourages his employers, mostly their opinion of him has to depend on the way he goes about his work.

REPORTS AND PREPARATION FOR DAY'S WORK

They probably require him to make a daily written report of his endeavors, showing the names of people he has seen, and what he has found out about them as prospects. The number of men he is able actually to talk with in any day is not great. He may as well stay in his own office attending to the office details of his work until nearly ten o'clock. Men especially dislike being disturbed at the beginning of the business day, when they have their mail to examine, and their daily affairs to get under way. Between twelve and two o'clock he often misses his hoped for interview because his man is out for luncheon. And after half past four men are hurrying to close the office day, and again are especially indisposed to see bond salesmen.

An ambitious salesman need not feel that the brevity of effective

calling hours necessarily curbs his desire to work. He can keep right on in the direct sales endeavor of planning his next day's work, thinking over his prospects and the best way of approaching them. To the extent to which he has been able to ascertain the securities they already own, he can be looking up information about the issues, and perhaps find some honest argument for advising the liquidation of a special security, which, if done, would put his prospect in funds to make a new commitment. And he has the Herculean task of keeping up with the current financial news.

LARGER PROFESSIONAL VIEWPOINT

Of this last labor there is no end. Each day brings its developments, its changes in the general economic situation, and in the vast multiplicity of specific enterprises. It is not enough that he knows by heart the facts of the issues on his house list that he must push for sale. With these securities he competes with all the other securities in the market. Speaking broadly, no security is positively good or bad; it is better or worse than some other security. The whole investing process turns on comparative values.

No amount of information, and ability to reason to good conclusions from the facts, will sell securities. Without the power to establish and develop business relations, the greatest knowledge of other things will go for nothing. But if the salesman has the essential ability, he can make a knowledge of economics, business, and especially of securities of great assistance. He can change his occupation from a job of peddling securities to a work of professional caliber.

Since every investor is interested in the securities he already owns, the salesman who knows a great deal about them has an advantage. Some investors are themselves well informed, and are quick to distinguish between competence and incompetence in the men who solicit their business. Many men admit security salesmen to their offices in the hope of learning something. Young salesmen seldom realize how large a part the hope plays in opening doors. If the hope is not disappointed, the salesman obtains his next interview more easily.

A salesman must never forget, nevertheless, that he earns his living by selling the securities he has to sell. Generally he is aware enough, however, that if he fails of some success in this endeavor, his living will cease to come from its present source.

With this limitation, the nearer he can get to being an investment adviser, the more strongly entrenched his selling will be.

Though the work of independent investment counsel, free to recommend any security in the world, has characteristics more agreeable than some aspects of the work of the bond salesman paid to sell the particular securities of his employer, the salesman need not be ashamed to press the honest merits in risk and price of the securities of his house on the attention of any investor at all qualified to form a judgment about the desirability of buying that kind of security. When he deals with those who are entirely ignorant of investment matters, he ought to refrain from taking advantage of that ignorance.

Though the Code of Fair Competition for Investment Bankers has no legal sanction, it represents ethical opinion of the gild. It necessarily deals in generalities with the problem of investment recommendations, and provides (Art. III, Sec. 4) as one of its rules: "Where an investment banker recommends to an investor the purchase or exchange of any security, he ought to have reasonable grounds for believing the security to be acquired by the investor is a suitable investment for such investor upon the basis of the facts, if any, disclosed by such investor as to his other security holdings and as to his investment situation and needs."

Counsel (Joseph C. Hostetler, Esq.) to the committee which drafted these rules utilizes an anecdote in some entertaining remarks on suitable investment: "One of the great stories of the investment business is of the man who applied to one of the Rothschilds for advice as to how he should invest twenty thousand pounds. Rothschild asked him, 'Do you want to eat well or sleep well? No man can do both on twenty thousand pounds.'"

Investment bankers have been rather too diligent propagandists of the idea of reliance on their judgment. They have themselves partly to blame for the strength of the resentment of many investors at any losses, a resentment which has expressed itself in legislation imposing great difficulties in carrying on the investment business. No investor should for a moment fail to be conscious of the fact that the salesman and his employer are not disinterested. Every investor should try to become sufficiently informed to deal with some intelligence. Critics of the processes of investment finance give nearly all their attention to the faults of the seller, and constantly seek to substitute legislation in place of the buyer's responsibility.

Judgment of investment risks imposes a great burden, perhaps too great for all but a few investors to carry without help. A reasonable regard for self-preservation requires the investor to be at least a little cautious of the investment banker bearing his proffered gift of assistance. Most investors do greatly need an unprejudiced adviser. Whether the business of investment counsel, which has had its beginnings, can be made to endure, and can become generally useful enough to include help to the small investor, which it has not yet offered, remains to be seen.

Under the British system the investor does not deal directly with the banker, but through a broker, and the salesman has no place in the system. However, though the broker apparently acts as agent for investors, he receives his compensation from the banker. We have no reason to disbelieve the statement that British banking houses adhere strictly to a uniform commission of a quarter of a point, so that the broker has no inducement to favor any house or any issue in making his recommendations to his client.

It would seem better if the buyer paid the commission, and the investment banking house refrained from doing any business directly with investors. Violation of such custom of bankers just possibly would be easier to detect than payment of more than a customary rate of commission. Whether or not, the broker would then be in breach of his fiduciary relationships to his principal, the investor, and subject to the legal consequences, if found out. Any compensation for services by commission exerts a pressure to recommend trading, when perhaps the retention of an investment would be better.

SALARY OF COMMISSIONS

Security salesmen commonly receive their compensation, or most of it, in the form of salary. Naturally the salary adjusts itself rather closely to the volume of business done. And here is one of the advantages of salesmanship as an occupation. The salesman can produce specific evidence of his value. But the payment of salaries to salesmen gives the banking house better control. The temptation to pressure and inaccurate statement is greater for the man eager to gain the immediate commission than for the one who will receive his next pay check regardless of the sale.

TRAINING OF SECURITY SALESMEN

Rules of the Code of Fair Competition for Investment Bankers, which we quote as representing standards of the business, provide (Art. VII):

Sec. 1. Supervision. Any investment banker who employs any salesman shall supervise the sales method of such salesman and his correspondence in relation to offers of securities for sale to investors; and any sale made by any such salesman to any investor, other than another investment banker, shall be approved by a partner, duly accredited executive, or branch office manager of such investment banker. Such approval shall be evidenced by a written endorsement made upon a copy of the memorandum of sale mentioned in Section 3 of Article VI, and each memorandum so approved shall be made a part of the permanent records of such investment banker and retained in his files for at least three years.

Sec. 2. Experience and Qualifications. (a) Except as hereinafter provided in paragraphs (b) and (c) of this section, no investment banker shall employ any person to act as salesman unless (1) such person shall have had at least two years' experience in the investment banking business or in a business a principal part of which related to securities; (2) shall be at least twenty-one years of age; and (3) shall be of good moral character; provided, however, that any person who has not had two years' experience in the investment banking business or in a business a principal part of which related to securities but who has been employed by an investment banker for a period of at least six months, and who is otherwise qualified as provided in clauses (2) and (3) above in this paragraph set forth, may be employed by any investment banker as a salesman if the compensation of the person so employed to act as salesman shall be straight salary and shall not include, in whole or in part, commissions upon securities sold.

(b) Any investment banker desiring to employ any person to act as a salesman, may make an application to the Regional Code Committee of the district in which such person is to be employed for permission to employ such person as a salesman. If a majority of the members of such Committee shall, after due hearing and consideration of such application, be of the opinion that the person proposed to be employed as a salesman is, by reason of his age, experience, standing and reputation, fully qualified to act as a salesman, such committee may in writing advise the investment banker who made such application to that effect, in which event such investment banker may employ such person without regard to any of the requirements of paragraph (a) of this section except the requirement set forth in clause (3) thereof.

(c) Nothing contained in either paragraph (a) or (b) of this section shall be construed to prevent any investment banker from continuing to employ as a salesman any person who is so employed by such investment banker at the effective date of the Rules.

Sec. 3. Solicitation at Residences. No salesman shall call in person upon, or telephone to, any customer or prospective customer at his home or residence for the purpose of selling to, or offering to sell to, or soliciting an offer to buy from such customer or prospective customer, unless such customer or prospective customer shall have previously given written permission therefor to the investment banker employing such salesman. As used in this section the term "salesman" shall include any investment banker, or any partner, officer or employee thereof who does any act or thing in this section described. This section shall not apply to the solicitation of business persons, retired or professional persons, or farmers.

Sec. 4. Orders Taken by Salesmen. Any investment banker who employs any salesman shall require that all orders taken by such salesman for the purchase of or subscription to any security shall be subject to acceptance and confirmation by such investment banker.

One surmises that, with the decision of the Supreme Court of the United States that much of the National Recovery Administration's control of business is unconstitutional, the approval of a Regional Code Committee will drop out. And one doubts if the provisions relating to solicitation will be observed.

Such code ideas impose no very onerous burden of training. They represent an opinion that the banking house had better keep its apprentice in the office for six months before it thrusts him off to sink or swim. During this period he can get something of the feel of the business. He can see the wheels go round. He may be given bits of work to do in looking up information. From time to time some of the larger distributing houses have given courses of instruction to their young men in training. If the prospective salesman has been to a school of business of college rank where he has learned something of accounting and banking, had a course commonly denominated Corporation Finance, and generally studied the ways in which business is carried on, he will recognize the significance of what he sees and hears more quickly than the man without such preparation.

Opinion differs as to the desirable length of the office novitiate. The longer a man sits at a desk the more reluctant he will be to take the plunge into the chill waters of solicitation — unless, indeed, he is unusually extrovert and finds a chair galling. After

all, the job he has to learn is that of dealing with people. When he has acquired enough knowledge of securities not to appear altogether ridiculous, perhaps the sooner he is about his real business the better.

AVERAGE SIZE OF SALES

The unit of issues is a million dollars: the unit of sales a thousand dollars. Though three ciphers disappear from the more important side of the decimal point, the bond salesman can still feel that the size of his transactions adds dignity to his employment. They have at least the magnitude of the sale of an automobile. If buyers would give as much thought to them as to the far less difficult business of selecting a car, our processes of investment finance would operate much better.

Sales to investors average about $3000 each. At this rate it will take 3333 retail transactions to market the issue. Every such sale involves persuading some investor to part with $3000 for a piece of paper. Probably anyone who has never tried to accomplish such a result has no vivid consciousness of the difficulties it usually presents. Ignorant investors on the whole increase rather than decrease the labors of bond salesmen.

Assume that the "spread" of our $10,000,000 issue is five points, i.e., that the bonds bought from the corporation at 90 are sold to the investor at 95. Congressional investigations discover that the bankers made a profit of $500,000, and headlines of the sensational press blazon the information to people whose annual income is $1000 more or less. That a substantial part of this shocking profit went to pay people in the same income brackets as those of the people shocked is never told.

Society should earnestly endeavor to find and to utilize methods of collecting capital more economical than those in use. The process of invention should go on in the mechanics of business, as in the mechanics of the fabrication of tangible things; and to the same end of lessening the labor required for a given result. But the writer hopes that, by the time the reader has finished these chapters on the marketing of securities, he will realize that the so-called profits of bankers include not only payment for the assumption of a risk, but also payment for a vast amount of work; and that both payments are rather widely distributed.

One can say what has been said in the preceding paragraphs

and still be far from defending every instance of bankers' profits. The investment business perhaps is no freer from scandalous episodes than other forms of enterprise, in all of which human selfishness becomes greed, and mingles with endeavor. But instances of evil are not the whole truth of investment banking any more than they are of life.

The Federal Securities Act of 1933 provides (Section 26, Schedule A, 17) for a disclosure in the registration statement of "all commissions or discounts paid or to be paid, directly or indirectly, by the issuer to the underwriters in respect of the sale of the security to be offered," and makes various other requirements intended to assure a publication of the gross profits the bankers hope to make on any issue. The writer might recommend an extension to all forms of merchandising of the principle of a disclosure of gross profits. It might well be salutary. But a special reason for it in the sale of securities is pointed out in the chapters on government regulation of the business.

STATISTICAL DEPARTMENT

What is called a "statistical department" carries on one division of the work of an investment banking house. Actually, the men employed in the loosely denominated statistical work have for their essential task the backing up of the salesman making the direct contacts with the investors. It may range all the way from real "research" to writing letters to "prospects" about issues the house has on its list. Though almost entirely engaged on the selling side, statistical men may do something on the buying side.

For example, if the partners are engaged in negotiating over the possible purchase of an issue of foreign government bonds, the statistical department may be occupied in looking up information about the resources, economic life, and government finances of the country involved. If the buying negotiations are concerned with an enterprise manufacturing automobile tires and other rubber goods, the department may look into markets for raw materials and finished product, other hazards of the rubber manufacturing industry, and hazards of the particular enterprise. Though the seller furnishes most of such information, the statisticians can be corroborative and supplemental, and at the same time can be formulating the data into selling representations of facts.

"Statisticians" may follow the daily financial news, and help

keep the salesmen informed about any developments affecting market conditions or the security issues in which at the moment the house is especially interested. This work may take the form of daily house bulletins to salesmen.

A customer or prospect may have asked a salesman a question about some house issue which the salesman was unable to answer, and he has asked one of the men in the statistical department to answer it for him. The salesman may be trying to work out a "trade" with some investor. A statistical man may obtain a quotation on the security to be traded in, and otherwise work out the basis on which the trade may be made. In this connection he will have to remember the rule under the Code of Fair Competition (Art. V, Sec. 6) that:

> No investment banker who is a participant in any selling syndicate or member of any selling group shall enter into any agreement or arrangement with any purchaser of the new securities being distributed by such syndicate or group whereby, either directly or indirectly, as a condition of the purchase, such investment banker will accept any other securities (except securities which are being refunded or redeemed in connection with or by means of such new issue of securities, or any securities maturing within six months after the date of such transaction) in trade in payment of all or any part of the purchase price of such new securities. The foregoing provision shall not, however, prevent such investment banker from accepting such other securities as agent for sale, in which case the investment banker shall make the usual charge for such services and such investment banker may allow the purchaser of the new securities to apply towards the purchase price thereof any net proceeds realized from the sale of such other securities.

This provision seems to relate more to fair syndicate practice, the relations of investment bankers towards each other, a prevention of essential price cutting, than to the practice of "trading out" as such. Since most sales of new issues take place in the course of syndicate operations, the section should affect trading out. Presumably a sale by the banker for the account of the investor of his security accompanied by a sale of bonds of the banker's issue to him will be called a "trade." Apparently the propriety of advising the sale of the old security still lies in the ethical sense of the banker unassisted by any specific provision of the Code rules. One may perhaps have some cynical misgivings about probable adherence to this ideal of trading out in the absence of an enforcing authority.

Let us return, however, from this digression to the statistical department. The banking house and its salesmen cultivate good will by offering to furnish present or hoped for customers with any specific financial information they may wish to have. The salesman passes the questions on to the statistical department, and some man there has the job of looking up the answers and writing a letter to the inquirers. The statistician may find an answer by a brief reference to one of the manuals, or he may have to telephone to, or otherwise interview, someone likely to have the information sought. Finding it and writing the letter may be the work of a few minutes or may require a day or two.

SELECTING SECURITIES FOR ACCUMULATION

Besides originating issues, or participating in the distribution of new issues, the banking house may from time to time accumulate a block of securities of some old issue in the general market. As a basis for such accumulation, the statistical department may search for issues selling "out of line." Prices represent the forces of investor opinion of relative values finding their result in the market quotation for particular issues. But the especially skilled judge of values may be able to form opinions superior to the average of opinion which the market price of a security expresses. So the banking houses may endeavor to pick out of the list securities in which the risk is less than the price indicates.

When it selects such a security, it may back its opinion by making purchases in the general market for its own account, anticipating that investor opinion will come to see that the relative value is greater than the present price indicates and consequent buying will bring the price into line. If the judgment of the house is correct, it may take advantage of the ensuing advance in price by selling from its holdings of the issue to its own customers. Such sales do not have the tendency to depress the market that selling in the general market, as through a broker on the stock exchange, would have. The house recommends the security to its customers on the basis of its opinion that the price should go still higher to come into line.

Such business differs from any speculation only in the opportunity the banking house has to liquidate without a directly price-depressing tendency. Work of the statistical department in searching for issues selling out of line may be of high order.

Formulation of the data from which it draws its conclusions may be an extensive piece of work.

SOURCES OF INFORMATION

Secondary sources of information in finance are so voluminous and so good that the statistician seldom has to look into original sources. Among the principal original sources are corporation annual reports and corporation mortgages. The great manuals published annually, *Poor's* and *Moody's*, present the essential financial facts, and are important tools of the business. *Standard Statistics* keeps the facts up to date on cards convenient for quick reference. It furnishes a new card when the facts change.

The Commercial and Financial Chronicle, published weekly, in its periodical supplements, presents a huge supply of facts. For ready references it furnishes full and carefully prepared indices. A long series of bound volumes of the manuals makes most of the library of the house. White and Kemble's maps give a pictorial presentation of the complicated mortgage liens of the railroad systems of the United States. Only the more frequently used sources of information have been mentioned, but these are enough to indicate the tools of the statistical department.

OPPORTUNITY FOR PROMOTION IN THE STATISTICAL DEPARTMENT

Though a large number of men interested in financial work have found employment in the statistical department, it cannot be recommended as a path to promotion in the investment business. As these pages have reiterated, the task of investment is selling securities. Salesmen directly further the performance of that task. A salesman who has built up a large clientele has a wedge by which he may open the way to enter the partnership. Though the reputation of the house he represents may have helped him greatly in developing his clientele, he may join the forces of a house of equally good reputation and carry most of his customers with him.

He may be ambitious to have an investment banking house of his own, that is, one in which he will be a senior and not a junior partner, a house in which his name will appear. By contenting himself with distribution for a time, not attempting origination,

he will not need a great amount of capital. He may have at least some small funds of his own, and with his selling abilities he can probably persuade someone with capital to join him. New banking houses constantly enter the field in this way.

A man with a selling temperament is more likely to develop the other abilities necessary for the business as a whole than a man in the statistical department is to develop the essential selling temperament. Recruits in that department commonly come from men whom the house has taken on as apprentices in salesmanship, who have failed to sell, but show such abilities as seem likely to make them useful in the other work. Perhaps not a third of the men who try selling succeed. Most of them drop out of investment banking altogether, and take up some other employment. Openings are not numerous for men who do not want to try selling.

Men who have never tried selling, or who, having attempted it, have failed, have, nevertheless, attained an influential and highly rewarded position in the investment business. Yet among those who occupy such positions these instances are rare. Probably our economic system based on the private ownership of wealth almost inevitably tends to place too high a valuation on selling ability. Yet this ability should not be underrated. It is essentially the power to influence men to action. Some who have it make bad use of it, and would under any form of economic organization.

CASHIER'S DEPARTMENT

Those engaged in the investment banking business call the man in charge of accounting, and in immediate control of securities and other funds, the cashier; and call his division of the personnel the cashier's department. Besides keeping the accounting records, this department does all the work of receiving and paying for securities bought, and of delivering and receiving payment for securities sold. It is responsible for the safekeeping of securities on hand. The cashier and those of his assistants who have to do with the receipt and delivery of bonds and stock certificates must be familiar with all the requirements for the transfer of securities.

If the house engages in the origination of issues, the cashier must be familiar with the operation of syndicates. He will have to carry on all the intricate detailed work of those his house organizes. He has a position of great responsibility and receives a

corresponding compensation. Yet it is in the form of a salary. Few cashiers are partners.

THE TRADER

Normally there exists a vast telephone market for securities, quite independent of the organized exchanges. This does not relate at all, or only incidentally, to the original distribution of an issue, but to securities already in the hands of investors. Since the transactions do not take place through the stock exchanges, it is often called an "over the counter" market. "Over the telephone" would be more literally descriptive. A banking house may have one or more men in its employ called "traders," who handle the work. Since it does not deal with the original market of the distribution of new issues, we will defer further consideration until we take up secondary markets.

FURTHER RULES (OF THE CODE OF FAIR PRACTICE) PERTAINING PRIMARILY TO RETAIL SALES AND PURCHASES

Reputable investment bankers do not give any guarantees of payment, or make any agreements to repurchase. Proposal of such agreements should immediately arouse suspicion. The business of dealing in securities is one of shifting risks, not of continuing them. If a dealer should make a practice of giving such agreements, his amount of contingent liability would soon be such that it would have little value to the investor.

On this subject the rules of the Code of Fair Practice, Article VI, Sections 5 and 6, provide:

> No investment banker shall, in any transaction involving the purchase of any security for the account of the customer or involving the sale of any security to a customer, agree with the customer, either directly or indirectly to guarantee that the market value of the security as it was at the time the security was bought for or by the customer will be maintained, or that the business of the issuer of such security will be successful in earning profits, or that the issuer will meet its promises and obligations; provided that the restrictions of this section shall not apply in respect of transactions in any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.

Sec. 6. Repurchase Agreements. No investment banker shall, in any transaction involving the purchase of any security for the account of a customer or involving the sale of a security to a customer, agree with the customer either directly or indirectly, to repurchase the security from the customer; provided that the restrictions of this section shall not apply in respect of transactions in obligations of the United States or any security guaranteed as to principal or interest by the United States, or of transactions in any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited, or to any repurchase agreement with any person whenever such repurchase agreement is limited to sixty days and is used as a substitute for borrowing.

The exception of agreements to repurchase United States Government securities may puzzle the reader. The writer has the perhaps unfair thought that this may appear in the rule with an eye of the draftsmen towards certain tax situations. Some States have the general property tax and assess the taxpayer on all property owned by him on a certain date of each year. Under well understood constitutional principles, obligations of the United States are not taxable by the States.

Other rules provide that:

No investment banker shall take or carry any account or make a transaction for any customer under any arrangement which contemplates or provides for the purchase of any security for the account of the customer or for the sale of any security to the customer, where payment for the security is to be made to the investment banker by the customer over a period of time in installments or by a series of partial payments unless

(a) In the event such investment banker acts as an agent or broker in such transaction he shall, immediately, in the regular course of business, make an actual purchase of the security for the account of the customer, and shall immediately, in the regular course of business, take possession or control of such security and shall maintain possession or control thereof so long as he remains under obligation to deliver the security to the customer.

(b) In the event such investment banker acts as a principal in such transaction, he shall, at the time of such transaction, own such security and shall maintain possession or control thereof so long as he remains under obligation to deliver the security to the customer.

No investment banker, whether acting as principal or agent, shall in connection with any transaction referred to in this section make any agreement with his customer under which the investment banker shall be

allowed to pledge or hypothecate any security for any amount in excess of the indebtedness of the customer to such investment banker.

Sec. 8. Information Received in Other Capacities. An investment banker who receives information as to the ownership of securities in the capacity of paying agent, transfer agent, trustee or in other similar capacity, shall under no circumstances make use of such information for the purpose of soliciting sales or exchanges except at the request and on behalf of the issuer.

Stated briefly (a) and (b) say, "Thou shalt not bucket."

The provision against agreements permitting repledging for amounts in excess of the debt for which the security is held as collateral refers to the waivers stock exchange brokers regularly procure from customers on margin accounts. Carrying on such business in its usual form requires that the customer waive various rights of a pledgor, including the right not to have the pledged security repledged for a greater sum than the debt due the broker. Presumably the prohibition, relating to repledge, in these rules for investment bankers will be interpreted so as to permit bankers who have also a stock exchange membership to carry on their stock exchange business as usual. It should be noted that Section 8 (c) and (d) of the Federal Securities Exchange Act of 1934 empowers the Securities and Exchange Commission to regulate some of these matters, and provides that:

Sec. 8. It shall be unlawful for any member of a national securities exchange, or any broker or dealer who transacts a business in securities through the medium of any such member, directly or indirectly — ***

(c) In contravention of such rules and regulations as the Commission shall prescribe for the protection of investors to hypothecate or arrange for the hypothecation of any securities carried for the account of any customer under circumstances (1) that will permit the commingling of his securities without his written consent with the securities of any other customer, (2) that will permit such securities to be commingled with the securities of any person other than a bona fide customer, or (3) that will permit such securities to be hypothecated, or subjected to any lien or claim of the pledgee, for a sum in excess of the aggregate indebtedness of such customers in respect of such securities.

(d) To lend or arrange for the lending of any securities carried for the account of any customer without the written consent of such customer.

Brokers have obtained consents on opening the account.

CHAPTER XXX

State Regulation of the Sale of Securities

Government in various ways regulates the sale of securities. Railroads under the jurisdiction of the Federal Interstate Commerce Commission must obtain the approval of that commission for the issuance and sale of any securities; and it may be, also, of various State commissions having jurisdiction. Approval of the State public utility commissions is required for the issuance and sale of securities of public utility corporation securities. There are the numerous State acts, commonly called Blue Sky Laws, regulating generally the sale of securities. And finally the Federal Government has entered the field of general regulation with its Securities Act of 1933.

GOVERNMENT REGULATION WHICH IS NOT PRIMARILY FOR THE PURPOSE OF PROTECTING THE PURCHASER OF SECURITIES

Control of the Interstate Commerce Commission and of the various State public utility commissions over the issuance and sale of securities is not for the purpose of protecting the purchasers of the securities, but rather a part of their jurisdiction for the purpose of rate regulation. The essential problem involved is that of a fair return to capital employed in the public service enterprises. Stated the other way, it is a problem of the regulation of rates, so that the rate shall not be unfair to the consumer in giving more than a fair return to capital. It is part of the problem that capital should be committed advantageously. A return for disadvantageously committed capital should not burden the consumer. Issuance of securities evidences an addition of capital in the enterprise. It is incidental that Interstate Commerce and Public Utility Commission regulation of the issuance of securities serves as protection to the investor.

GOVERNMENT REGULATION OF THE SALE OF SECURITIES FOR THE PROTECTION OF THE INVESTOR

Since the intangible values inherent in a share of stock or a bond are intricate, and often difficult to analyze, they have afforded abundant opportunity for the fraudulently disposed, and the reckless, to impose on the ignorant and the credulous. The Common Law provides remedies for fraud — rescission, damages; but the remedies, of course, are not available until after the fraud is committed. Then the injured person may have to pursue the wrongdoer in a jurisdiction different, and perhaps distant, from that of the residence of the man who seeks the remedy.

After a pursuer has resorted to a court of jurisdiction, and obtained judgment or decree, he may not be able to find any assets of the wrongdoer. The fraudulent person has dissipated the proceeds of the sale, and any other assets he may have had, or he has successfully resorted to concealment of his assets. As we shall see, legislation has endeavored to protect purchasers of securities not only against fraud, but also in transactions not tainted with the elements of fraud at Common Law.

Statutes enacted to this end have become commonly known as Blue Sky Laws. The origin of the term is sometimes referred to the unclouded prospects pictured by promoters of the sale of securities, and sometimes to their willingness to capitalize things as lacking in the elements of property value as the blue sky.

LEGISLATION DESIGNED TO PROTECT THE INVESTOR

Such legislation, designed to prevent damage rather than offering a remedy for injury done, ranges all the way from State intervention only on a prima facie case of fraudulent transactions to prevent their continuance, to rigorous requirements that securities may not be offered for sale at all until the consent of a designated State authority has been obtained. State legislation to this end may be classified as statutes:

(1) Authorizing State authorities to intervene, but not making any requirements as a condition of sale unless the State authority initiates action.

(2) Authorizing sale pending investigation and consent to continued sale, or denial of consent, by the State authority.

(3) Preventing sale until investigation and consent.

We will defer consideration of the Federal Securities Act of 1933 until after consideration of the State statutes. The third type of statute, and even the second, impose a considerable hardship on the distributor of securities. If the issue is large, he requires a sales area larger than the territorial limits of any one State. Even if an issue is not large, the clientele of an investment banker is likely to extend through at least several States. From the viewpoint of the individual distributor, the hardship is almost as great for the small as for the large issue; the difference between small and large issues in distribution is that a greater number of distributors join in marketing the large issue.

A distributor of securities wants to reduce his risk as much as he can. In the normal course of his business he makes a commitment with the issuing corporation to purchase securities; or he underwrites a stock issue subject to preëmption. The longer the period that must elapse between his commitment to buy and his sale, the greater his hazard of market conditions. In practical operations he cannot induce the prospective buyer to contract to purchase from him conditional on his purchase from the issuer.

Bankers must have such assurance of being able to deliver as at least a contract with the issuer to sell affords. Though sometimes they may be successful in contracting to sell the entire issue before the day arrives to take delivery from the issuer, they have by so doing merely reduced the difficulties of financing the turnover. They assumed the risk when they entered into the contract to purchase.

Under the third type of statute a banker may not lawfully sell until he has procured the consent of a State authority. Obtaining this consent may require only a few weeks, or it may require a number of months, depending on the elaborateness of investigation, the diligence of the State authority, and the amount of work which may be piled up. It may be remarked, as bearing on the public policy of these statutes, that in the long run those who bear risks must be compensated; so in the long run distributors of securities must charge a greater difference between their buying and their selling prices to compensate for a greater risk; to say nothing of what they must charge to cover the costs of complying with the statutes.

Conditional commitments to purchase securities from the issuer, subject to obtaining consents of the required number of jurisdictions to distribution, do not avoid the hazard of the

market. The price of purchase from the issuer is determined at the date of the conditional commitment, and market conditions may change to the disadvantage of the distributor before he can obtain consents.

Even the second type of statute, under which the distributor may sell, pending determination of his application, imposes, besides the costs of compliance, an element of uncertainty. An issuer can hardly afford to make a contract to sell its securities, under which it undertakes to deliver an undetermined part, without having a right to deliver and receive payment for the rest. If it receives only part of the expected funds, they may be essentially useless; and the capital charge they impose, an expense without adequate recompense. For example, part only of the funds may not be sufficient to carry out the addition or improvement for which funds are sought; and the amount obtained may not be useful to the issuer for any other purpose.

Yet if the distributor should make a definite commitment to purchase, he might find himself unable to obtain necessary State consents to distribute. Such a situation might readily cause his insolvency. His own capital would seldom be sufficient to complete the purchase from the issuer. He relies on his distribution power to give the asset of the securities the liquidity necessary to make them available collateral for a loan. If State consent to distribute is refused, his ability to distribute the issue is destroyed, and it has no availability as collateral. He is under an obligation which he cannot meet.

STATUTE UNDER WHICH DISTRIBUTOR MAY PROCEED UNLESS AND UNTIL STATE AUTHORITY INTERVENES

New York has a statute, commonly known as the Martin Act, and officially as Article 23A of the General Business Law, under which the distributor may proceed with sale until the Attorney General takes the initiative to prevent it. Obviously the distributor takes the risk that the Attorney General may intervene. However, since the statute aims at protecting the purchaser from fraud and not from his own ignorance, presumably this hazard is much less than that of a statute which aims at greater protection of the investor against inexpedient commitments. Though the intervention of the Attorney General may not be well founded, and therefore do an injustice to the distributor, the statute repre-

sents the minimum of risk to the distributor of any protection to the investor which extends beyond the Common Law liability of the seller for fraud.

The statute requires a dealer in securities to file in the Department of State a statement called a "state notice." This gives the names and the business and residence addresses of the personnel, i.e., the partners, or the principal officers and agents of a corporate dealer. The notice must disclose any connection with the security business they have had during the preceding five years, and the names of the last three issues of securities they have offered. It must also state, as to each member of the personnel, whether or not he has ever been convicted of a criminal offense in connection with any transaction involving the offer for sale of any securities; and whether or not he has been enjoined or restrained from selling or offering for sale securities in any jurisdiction.

When a dealer offers an issue of securities for sale he must file a further notice, giving the name of the security and the name, post-office address, and State of organization of the issuer. A syndicate manager may file this notice on behalf of all dealers in the syndicate.

The department publishes these notices in the State Bulletin. From them the Attorney General can know who are engaging in the security business in the State, and keep an eye on what they are doing.

The statute does not give any officer, commission, or court, authority to pass on the fairness of bargains in the sense of equality of *quid pro quo*. It aims at fraud in providing that an investigation may be made; in requiring the dealer to furnish information to the Attorney General. In the language of the statute, authority is given to investigate "Whenever it shall appear to the attorney general either upon complaint or otherwise, *** that any person, partnership, corporation, company, trust or association shall have made, makes or attempts to make in the State fictitious or pretended purchases or sales of securities or commodities, or shall have engaged in or is about to engage in any practice or transaction or course of business relating to the purchase or sale of securities or commodities which is fraudulent or in violation of law and which has operated or which would operate as a fraud on the purchaser *** any one or all of which devices, schemes, artifices, fictitious or pretended purchases or

sales of securities or commodities, practices, transactions and courses of business are hereby declared to be and are hereinafter referred to as fraudulent practice or fraudulent practices." More broadly, the Attorney General may investigate whenever he deems it in the public interest that an investigation be made. He is empowered to subpoena witnesses, examine them under oath, and to require the production of any books or papers which he deems relevant or material to the inquiry.

If the Attorney General believes that the dealer has engaged in fraudulent practices, or is about to engage in them, he may apply to the court for an injunction; and if fraudulent practices have been or are being engaged in, the injunction may permanently restrain the dealer from doing a security business in the State. On proper showing the court may issue a preliminary injunction, which it will make permanent on proof.

What has been said of the New York statute omits much and presents only enough to indicate its tenor. It has been discussed at this length as legislation which does not seek to protect the investor from his ignorance, lack of competence to formulate judgments, or from lack of diligence in considering and investigating before making a commitment. Probably the statutory definition of fraudulent practices somewhat enlarges the Common Law concept of fraud. But accepting the idea of fraud as so defined, the statute does not aim beyond it.

STATUTES REQUIRING THE CONSENT OF STATE AUTHORITY AS A CONDITION PRECEDENT TO SALE, OR AS A CONDITION OF CONTINUING SALE

In our classification of Blue Sky Laws, we have divided those statutes which prohibit any selling before express consent of the designated State authority from those which permit the distributor to proceed with selling pending a decision on his application for consent. The burden on the distributor of a statute prohibiting sale until consent is perhaps greater than that of a statute permitting sale until consent or refusal of consent. But both classes of statute are alike in requiring the distributor to initiate action, and in requiring consent immediate or ultimate.

These statutes aim at much more than the prevention of fraud. They aim in the direction of a fair bargain in the sense of equivalence in *quid pro quo*. They aim in the direction of protecting

the investor from his own ignorance, incapacity, or lack of diligence in the business of investing. Their purpose is as stated, for example, in the Michigan statute: "The right to sell securities in this State shall not be granted in any case where it appears to the commission that the sale of such securities would work a fraud, deception or imposition on purchasers or the public, or that the proposed disposal is on unfair terms." (P. A. 1923 Act 220, Sections 1–33.)

Quotation of statutes is for purpose of illustration only. For action, of course, the statute should be checked to date with the decisions under it.

Such statutes generally proceed along three lines of requirement.

(1) The dealer (i.e., the principal in the distribution) must procure a license.

(2) Each salesman acting as agent for the dealer must procure a license.

(3) Consent of the State authority for the sale of securities of each particular issue must be obtained.

Commonly the statute sets up a special commission for administration of the Blue Sky Laws. Frequently, however, it adds the powers under it to those of some existing State authority, as to the Commissioner of Corporations, or to the State Bank Commissioner, or to the Secretary of State, and so on.

In requiring dealers and salesmen to procure a license, the object is to keep out of the business of distributing securities in the State men of such character that their dealings might be contrary to the purpose of the act. The expression of qualification for a license is usually nebulous — as a person of "good repute." The lines along which judgment of qualification will be formulated appear in the statement of preliminary information which the applicant must furnish.

Again quoting the Michigan statute:

> Any person desiring a license either as a dealer or salesman shall apply therefor upon application forms to be furnished by the Commission, showing the name, age, residence, business address, principal occupation and antecedent business experience of the applicant, and such other personal facts as the commission shall require, including references or recommendations as to the personal integrity and financial standing of the applicant.

Or, as the Massachusetts statute provides:

> No person shall sell any security within this Commonwealth *** unless he is registered as broker or salesman by the Commission. *** An application for original registration shall state the applicant's name and residence, mailing address, together with any other relevant information which the Commission may prescribe, and, if a broker, the place where the registered business is to be conducted. It shall be accompanied by a certificate of two citizens of the Commonwealth that in their opinion the applicant is, or, in the case of an organization, that the partners, trustees, directors and other officers and managing agents are honest and of good repute. When required by the Commission, each application for such registration as a salesman or for the renewal thereof shall be accompanied by a photograph, of the type known as a passport photograph, of the applicant, which shall be retained permanently in the files of the department and become part of its records. (Massachusetts General Laws, Chapter 110a, as revised by L. 1932, c 290.)

It is not, however, the qualification or licensing of dealer and salesman that causes the great difficulty. When a dealer has decided that he wishes to include a State within his selling territory he can qualify as principal and have his salesmen qualify as agents. The requirement does not increase the hazards of his course of business. The requirement for qualifying each issue of securities that is to be offered for sale is another matter. Before we take up the process of qualifying an issue, however, we will consider another aspect of the legislation, that of the acts prohibited.

A prohibition of selling securities which have not been qualified would be inadequate. The word "sale" has a precise meaning — the passing of title under a contract of sale. Under our multiplicity of jurisdictions the purpose of the act might be evaded. A salesman in Ohio for a Chicago dealer could in Ohio enter into a contract for the sale of a security and under the contract have title pass, i.e., the "sale" take place outside of the State of Ohio. Since the intent of the parties to the contract governs the time when title passes, an avoidance would be especially easy. The securities are in the possession of the dealer in Chicago (or pledged there for a loan). The contract need only provide expressly that title shall pass at the time of making the contract, with a reservation of possession to secure payment of the purchase price.

Or a contract could provide that the buyer should transmit funds to a bank in Chicago, which would take delivery of the

security and pay for it. Since delivery and payment are to be at the same time, it is apparently the intent of the parties, who have not expressed their intent, that title should pass on delivery. On a mere prohibition of selling, a course of business could be followed that would result in Ohio investors buying unqualified securities without any violation by the seller of the law of Ohio.

So the statutes prohibit making contracts in the State to sell unqualified securities. This provision seems to make it more difficult to distribute securities in the jurisdiction without conforming to the statute. But under the regular practice of the security business a salesman does not immediately enter into contracts with the purchaser. He takes an order subject to confirmation by his principal, the dealer. The transaction is "confirmed" in Chicago. Presumably the course of business constitutes an offer in Ohio by the investor to purchase, and acceptance of the offer in Chicago, with a consequence that the "contract" is made in Chicago, and the provisions of the Ohio statute prohibiting contracts to sell are not violated.

Ohio has jurisdiction over acts in Ohio, not over acts in Illinois. The salesman is not even "offering to sell," an act which the statutes regularly prohibit. The legal "offer" comes from the prospective purchaser. If there were any doubt about the place in which the contract of sale was entered into, or the offer to sell made, in the usual course of business, the transaction could easily be arranged in such a way as to remove the doubt. Essentially, however, in the ordinary course the salesman is not selling, or even making contracts to sell, but merely soliciting for contracts and sales, which may be entered into elsewhere.

Therefore the statutes prohibit soliciting sales of securities. With that provision the activities of the salesman are blocked. There is a prohibition of what the salesman must do if he is to be a salesman. Whatever the future development of the course of business in securities may be, for most of the past half century securities have been distributed largely through the activity of salesmen. Under conditions as they have existed, a prevention of salesman activity not expressly authorized by the statute is largely effective of the purposes of the Blue Sky Laws.

Still there is the possibility of doing business by mail. Under the principles indicated in connection with the activities of salesmen, it would be entirely possible to transact business by mail and keep all sales, contracts of sales, and offers to sell out of the

jurisdiction. But soliciting is another matter. Presumably any letter, circular, newspaper or periodical advertisement must be a solicitation. Presumably, too, the State has jurisdiction to prohibit the insertion of any advertisement in a newspaper or periodical printed in the State.

But has it jurisdiction to prohibit the receipt of a letter, or of an advertisement printed and mailed outside the State? Though one would have thought not, the Supreme Court of the United States on application for an injunction did not enjoin the Blue Sky Authority of the State of Michigan from enforcing the statute against a dealer outside the State who stated that he had no place of business in the State and was not then sending agents into the State. Blue Sky legislation, in the generally adopted form we are now considering, bristles with constitutional questions. We will mention some of them briefly later. At this point we will remark only that the constitutionality of the legislation is generally upheld.

Of course a dealer can refrain from inserting an advertisement in a newspaper printed in a State. He can refrain from sending letters into the State. But must he inquire of any periodical which he contemplates as an advertising medium whether it has any circulation in any of the States where he has not qualified his issue? If so, let us hope the offense is not extraditable, or that in a criminal case judge and jury would temper their justice with as much mercy as they could.

EXEMPTIONS FROM THE ACT — EXEMPT SECURITIES

Certain classes of securities are exempted from the operation of the act. Such exemptions serve two purposes. They ease the burden on dealers, and relieve the State authority from labor. They vary a good deal from jurisdiction to jurisdiction. Generally they include securities of the United States, and of Federal agencies, such as National Banks and the Federal and Joint Stock Land Banks, and bonds of States of the United States, and of municipalities in these States. Frequently they exempt bonds of foreign governments.

Usually the acts exempt securities of railroads and public utility corporations, which are issued under the supervision and on the consent of the Interstate Commerce Commission, or of a State public utility commission. Since such securities have al-

ready come under the scrutiny of a public authority, it is presumed to be unnecessary to subject them to further examination.

Sometimes the acts exempt securities listed on certain stock exchanges, especially on exchanges which require the filing of information not only on listing, but annually thereafter. In such a case the security has come under the scrutiny of the listing committee, whose members presumably are qualified to pass judgment on it, and presumably are not identified with its issuance. But in this exemption the acts containing it have a slant towards publicity of information enabling the investor to formulate a reasoned conclusion for himself.

Another exemption opens the door rather widely. Some acts do not require the qualification of securities listed in a standard manual of information. The act is likely to leave to the security commission the decision as to what manuals are acceptable under this exemption. Presumably they would include *Poor's* and *Moody's*. Such an exemption abandons any attempt to pass on the fairness of the bargain offered, and relies on publicity. Since the manuals publish only as much information as is available, which may not be a disclosure of facts adequate for the formulation of a judgment, the exemption on the score of publicity is hardly well taken. If the acts went no further than an attempt to reach fraud, the exemption would have a basis. The manuals are not likely to include fraudulent issues.

In a similar manner the list of exemptions may run to a considerable length. Only certain common ones have been named merely to indicate the idea.

EXEMPTIONS FROM THE ACT — EXEMPT TRANSACTIONS

Since the Blue Sky measures were intended to reach the business of dealing in securities, it became necessary for the draftsman to provide that they should not cover too much. General provisions against selling, contracting to sell, offering for sale, soliciting, negotiating, etc., cover the dealings of an investor who wants to sell a security he owns as well as of a dealer who is distributing an issue. Though the individual investor in disposing of his security may defraud or take an unfair advantage, his isolated transactions are not so injurious to the community as the continued transactions of one engaging in the business of distributing securities.

Moreover, it would be relatively a greater hardship on the investor to require him to get the consent of a State authority before he could dispose of his security than to make such a requirement of a distributor, who, after qualifying his issue, can make a whole series of transactions without further application. Besides, an attempt to interfere with contracts between men, not made in the course of a business, presents a more serious constitutional difficulty than an attempt at the regulation of a business. So by the use of some phrase or other the statutes exclude from their application transactions not in the course of a business. Often they elaborate by expressly excluding judicial sales, and sales by pledgees.

Commonly, too, the statutes declare an express exemption of sales to dealers, and often of sales to financial institutions. It is presumed that the managers of financial institutions have skill enough to avoid fraud, and to see that they have a fair bargain. Often the offering by a corporation of preëmptive rights to its own stockholders is exempted, and the exchange of securities on a consolidation or merger.

QUALIFYING THE ISSUE

In detail the course of qualifying an issue for sale varies considerably from jurisdiction to jurisdiction; in general it is the same. The dealer, or the issuer desiring to sell, must present to the State authority certain information indicated by the statute. The administrative authority has the right to call for additional information, and, if it desires, to make an independent investigation. Information presented must be under oath. The State officers examine the data before them, and either consent or decline to consent to the sale of the issue in the State. Sometimes the act expressly provides for an appeal from the decision of the administrative authority to the courts. If it does not, still, presumably the matter could be brought before the courts on application for a writ of mandamus.

Most of the acts require fairly full information — incorporation papers, resolutions on issuance, balance sheets, income accounts, and, it may be, even appraisals. Since this information is only what the dealer ought to have anyway, the requirement would not be an unwarranted hardship, if it were uniform. But in detail and in form of presentation the jurisdictions differ widely. A

funds he parts with? Though most of the statutes leave the matter to the discretion of the State authority, some deal specifically with it. Michigan provides that "the commission may also limit the price at which the securities, either of par or no par value, may be sold, and allow a commission not to exceed twenty per cent of the sale price, such percentage to include all expenses incidental to such sale, including advertising or any other expenses chargeable in any way to the sale of such securities."

If government is to interfere at all in freedom of contract in the distribution of securities, here is one of the points where regulation may well be applied. A cost of twenty per cent or more for raising capital probably indicates either too great a burden on the enterprise or socially unjustifiable profits to the distributor; or, it may be, something of both.

CONSTITUTIONALITY

When Blue Sky Laws have been challenged as unconstitutional, they have generally been sustained as a proper exercise of the police power of the State. It has been contended that they are burdens on interstate commerce and therefore beyond the authority of the State; that they impair the right of contract; that they are an unlawful delegation of power (legislative and judicial); that the various classifications of securities and distributors create unlawful discriminations; and that they take property without due process of law. Special aspects of particular acts have been held unconstitutional in State and lower Federal courts, and it seems possible that the Supreme Court of the United States would sustain at least some of these adverse decisions, if they were brought before it. But the highest court has upheld the broad general tenor of the acts.

At the time of the initiation of this legislation, which became general in 1914, 1915, and 1916, the investment banking fraternity was of two minds about it. Some were disposed to welcome it as tending to discourage dishonest and reckless distributors, and to make funds which had gone into their securities available for the sounder issues. Bankers favoring it hoped that a reduction of loss from fraudulent or ill-considered distribution would tend to raise the general reputation of the business, and lessen the difficulties of selling.

Others took the position that they were merchants in securities,

buying and selling their wares, and subject to the same responsibilities and possessing the same rights as any merchandiser. They resented special interference with their business, and foresaw the burdens the legislation would impose on them.

With this division of opinion, they did not as a group, through their then recently organized Investment Bankers Association, take any stand. Probably more favored the idea of legislation than opposed it; probably, however, many who favored some type of legislation did not like the type which became general, requiring them to obtain consent for the sale of each issue.

Legislation which endeavors to forestall fraud in the securities business, which provides for inquiry by a public authority into adequacy of consideration, i.e., whether the dealer is selling something which may reasonably be considered worth what he receives for it, distinguishes the distribution of securities from other types of business.

It does what the Common Law does in distinguishing the business of the common carrier and the innkeeper; and what the statutory law does in distinguishing those businesses which we describe as public utilities. A type of legislation we have not yet considered, which requires the seller to furnish information, and so compels him to make representations, likewise sets the security business apart from other businesses. And there are reasons for special treatment. Whether the reasons are adequate or not, it is the present public policy to regulate the business in ways in which, with such exceptions as we have indicated, other businesses are not regulated.

Values dealt with in securities are difficult to judge. Many, perhaps the great majority of buyers, seek to dodge the difficulty. Probably most people give more real thought to spending $50 for clothing than to parting with $1000 and multiples thereof to buy a security. Probably their ability to judge the worth of the clothing is greater than their ability to judge the worth of a security. But in other fields it has been public policy to encourage the buyer to develop judgment by requiring him to accept responsibility.

Though much abuse has been heaped on the phrase *caveat emptor*, "let the buyer beware," its tenor is just that: to encourage men to develop capacity, to consider wherein value lies and to estimate its extent. Application of the principle does give advantage to the man who undergoes the labor of acquiring

knowledge, an advantage to the diligent over the lazy. Stated less attractively, it gives an advantage to the strong over the weak. What constitutes fair and unfair advantage is necessarily a constant problem of any society organized on a principle of contract.

Along with the problem of fair and unfair advantage in the sale of securities goes the problem of creating favorable conditions for individual voluntary provision for the future. Probably the thought of limiting the general social waste of improvident use of capital does not enter into the fundamental ideas out of which Blue Sky legislation arises. Though individual provision and social providence have a correlation, it is the individual provision that is here the concern of the legislator. The voluntary nature of such insurance moulds character and adds to the dignity of human beings.

It is important that the individual be not thwarted and discouraged in his efforts by being led astray. If a man saves twenty-five per cent of his income for such provision, he must have an income of $4000 a year to save $1000. For the purpose of future provision that $1000 represents a year of life of the individual. Losing the amount not only causes his purpose to fail of its end, but tends to destroy his morale, to break down the will to provide. Endeavors to avoid this social loss may justify such legislation as Blue Sky Laws. Probably the loss during the past twenty years has not been quite so great as it would have been without this legislation.

CHAPTER XXXI

Federal Regulation of the Sale of Securities

From the beginning of the experiment of the States in regulating the security business, expressions of a desire for Federal Blue Sky legislation have appeared. Harassed dealers have hoped that compliance with a Federal act might relieve them from the burden of multifarious State acts. Others wishing for a more nearly adequate control of the security business saw the difficulties of State control, and hoped for Federal legislation to supplement it, or to take over the entire control, as some of the dealers desired. Probably few people gave any careful consideration to the problems of Federal legislation in this field. It was intended that the Federal Trade Commission's powers should include regulation of unfair practices in the interstate sale of securities. But certain defects make its powers ineffectual. From 1913 to 1933 several bills were introduced in Congress to regulate interstate traffic in securities; but, though they passed one or the other of the houses, there was lack of public pressure and the legislation never came to enactment. Finally, however, as part of the legislative program of the administration which came into office March 4, 1933, Congress enacted a Federal Blue Sky Law under the official title of the "Securities Act of 1933." (Amended 1934.)

The act places itself squarely on the jurisdiction of the Federal Government over interstate commerce and the post office. Probably in part for the purpose of helping overcome any doubts that may exist as to whether dealing in securities is commerce, the act provides among its definition of words and phrases used in it that "The term 'interstate commerce' means trade or commerce in securities or any transportation or communication relating thereto among the several States," etc. For Congress to say that securities are objects of interstate commerce does not make them so. Still, perhaps the draftsman of the measure was hopeful

that the declaration might lend cheer to a court desiring to sustain the constitutionality of the act. However, as we have seen, the State acts have been challenged as interfering with interstate commerce, the challengers assuming that securities are objects of commerce.

What Federal power or powers Congress relied on as giving the Federal Government authority appear from the enumeration of things prohibited. It needs to be remarked here that the act provides for a registration of securities. Leaving for later consideration what it means by registration, we will note that Section 5 states:

(a) Unless a registration statement is in effect as to a security, it shall be unlawful for any person, directly or indirectly —

(1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell or offer to buy such security through the use or medium of any prospectus or otherwise; or

(2) to carry or cause to be carried through the mails or in interstate commerce by any means or instruments of transportation, any such security for the purpose of sale or for delivery after sale.

(b) It shall be unlawful for any person, directly or indirectly —

(1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to carry or transmit any prospectus relating to any security registered under this title, unless such prospectus meets with the requirements of section 10; or

(2) to carry or cause to be carried through the mails or in interstate commerce any such security for the purpose of sale or for delivery after sale unless accompanied or preceded by a prospectus that meets the requirements of section 10.

A clause, now repealed, provided that:

(c) The provisions of this section relating to the use of the mails shall not apply to the sale of any security where the issue of which it is a part is sold only to persons resident within a single State or Territory, where the issuer of such securities is a person resident or doing business within, or, if a corporation, incorporated by and doing business within, such State or Territory.

The repealed clause (c) of this section seems to indicate a fear of the draftsman that it is not safe to rely on Federal authority over the mails as such.

The thread on which the constitutionality of the act hangs is thin. Perchance it will hold when its substance is finally tested.

TYPE OF ACT — REQUIRING DISCLOSURE OF FACTS

Though some of the State Blue Sky Laws make the information furnished to the public authority a public record, therefore open to examination by anyone, and to that extent are acts requiring a disclosure of facts, they do not primarily rely on disclosure directly to the investor for their effectiveness, but on the opinion of the public authority based on the disclosure of facts to it. From the beginning of Blue Sky legislation in the United States, and earlier, many have advocated reliance on a compulsory disclosure to the prospective investor of pertinent facts from which he could draw his own conclusions.

One flaw affects the soundness of this idea. The kind of man who is diligent enough to examine information, and intelligent enough to form a well reasoned judgment on it, knows enough not to invest unless such information is given him. There are many securities for which information is available; and if all investors were diligent and intelligent, all sellers of securities would have to furnish information. The thought that diligent and intelligent investors demand all pertinent information is not quite true.

Certain courses of business become customary. It has not been customary to disclose the spread between the price received by the issuer and the price asked by the dealer. Indeed it is not customary for dealers in dry goods and groceries to disclose their profits. Until discrediting the profit motive became the endeavor of certain circles in recent years, it was felt, by the buyer as well as the seller, that the manufacturer's or merchandiser's profit is a matter of the seller's private concern. The question for the buyer is whether, at the price asked of him, the bargain proposed is advantageous to him. Good taste in the market place prohibits inquiry into the price paid by the seller.

Even the experienced investor has not included an inquiry into dealer's profits as part of his investigation. Yet there is some difference between buying a pair of shoes and making an investment. The shoes will wear so long and present a certain appearance. The price paid for a given pair of shoes does not affect them in either of these respects, nor the amount of that price which the dealer takes as his profit. But the amount of the sales price which a dealer in securities has paid to the issuer directly affects the quality of the investment. That quality depends on the earning power of the issuer.

If the enterprise has the benefit of only 50 cents of each dollar paid by the investor, its earning power is less than it would be if it received 95 of each 100 cents the investor parts with. Yet the investor, constrained by the usages of the market, has customarily endeavored to come to a conclusion about the bargain proposed without knowledge of the pertinent fact of dealer's profit.

Some States, apparently recognizing that private corporations might be regarded as having a quasi-public character, have long required the filing of annual statements of certain facts of the corporate affairs. As public records these statements served in some measure to make the information they contain available to the prospective investor. At best they are half-hearted compromises of any policy of corporate publicity.

Advocates of publication of corporate facts for the benefit of the investor have long pointed to the prospectus provisions of the British Companies Act as a source from which we should draw, and the draftsman of the Federal Securities Act of 1933 has drawn on it, though hampered in his work by thoughts of constitutional limitations. The British act requires the filing and publication of a statement, called a prospectus, disclosing in some detail facts about the affairs of the corporation pertinent to investing.

INFORMATION REQUIRED — REGISTRATION STATEMENT

In setting forth the information required to be filed, the draftsman did a sound piece of work. The requirements are extensive, but not more than they should be. They will involve substantial labor and cost, but if it were possible to get away from the numerous differing State requirements the burden would be tolerable. With the vested interest of officeholding, one can hardly hope that this will happen. The States would do well to adopt the information requirements of the Federal measure, and in this respect make the State Blue Sky legislation uniform. Then the information could be manifolded by printing or otherwise, and used for every Blue Sky qualification.

Of course the act calls for articles of incorporation, by-laws, balance sheet, and profit and loss or income account information. The profit and loss statements must go back annually for three years, if the enterprise has continued for that period. The following explicit provision in Schedule A (26) will tend to clarify the profit and loss statement and show its real significance:

*** Such statement shall show what the practice of the issuer has been during the past three years or lesser period as to the character of the charges, dividends or other distributions made against its various surplus accounts, and as to depreciation, depletion, and maintenance charges, in such detail and form as the Commission shall prescribe, and if stock dividends or avails from the sale of rights have been credited to income, they shall be shown separately with a statement of the basis upon which the credit is computed. Such statement shall also differentiate between any recurring and non-recurring income and between any investment and operating income. Such statement shall be certified by an independent public or certified accountant.

Several requirements substantially supplement the balance sheet information. They are set forth in Schedule A (10) and (24), and are:

(10) a statement of the securities, if any, covered by options outstanding or to be created in connection with the security to be offered, together with the names and addresses of all persons, if any, to be allotted more than 10 per centum in the aggregate of such options; ***

(24) dates of and parties to, and the general effect concisely stated of every material contract made, not in the ordinary course of business, which contract is to be executed in whole or in part at or after the filing of the registration statement or which contract has been made not more than two years before such filing. Any management contract or contract providing for special bonuses or profit sharing arrangements, and every material patent or contract for a material patent right, and every contract by or with a public utility company or an affiliate thereof, providing for the giving or receiving of technical or financial advice or service (if such contract may involve a charge to any party thereto at a rate in excess of $2,500 per year in cash or securities or anything else of value) shall be deemed a material contract.

These provisions read like a review of scandalous financial proceedings of the past two decades. Presumably new scandalous methods will develop. What they will be cannot well be foreseen. They will have to be met as they arise. But these provisions probably will do something towards preventing continuance of old undesirable conditions. Options on securities given by the issuer, at least options good for more than a very brief period of time, are too likely to create a highly undesirable situation. But the effect of such options has been considered elsewhere, and we need not discuss it further at this point.

Contract liabilities do not generally appear in the balance sheet. Yet they may force an enterprise into insolvency. On the other hand a contract may be an asset of great value. In

either case the facts are material to judgment of a security; but on a sale of an issue a voluntary disclosure of a liability likely to result in loss is less probable than of the asset value of a profitable contract. The phrase limiting the requirement of disclosure to contracts made "not in the ordinary course of business" may be troublesome. Is a contract for the entire output of an enterprise for a year or more one not made in the ordinary course of business? Correspondingly is it not in the ordinary course of business to make a contract running a year or more for a substantial part of the materials used in an enterprise? Such contracts are ordinary, yet are among the very situations which may make or break a business. These provisions place on those preparing the registration statement a hardly tolerable burden of deciding what contracts are not in the ordinary course of business.

Let us hope that "profit sharing arrangements" will be interpreted to include such arrangements with the mass of employees as well as those with executives. It is the latter, to be sure, which in the past have provoked unfavorable comment.

Likewise, going to the question of the probable ability of the enterprise to provide a return on the capital, the act requires a statement of:

> (14) the remuneration, paid or estimated to be paid, by the issuer or its predecessor, directly or indirectly, during the past year and ensuing year to (a) the directors or persons performing similar functions, and (b) its officers and other persons, naming them wherever such remuneration exceeded $25,000 during any such year.

Does the "wherever" mean the remuneration for each person? Apparently under this clause a statement might make a modest showing as to salaries, which, however, might become excessive after the lapse of a year. Obviously the act could not properly tie the hands of a management for a long period of time. This chapter is not the place to deal with excessive salaries. Unfortunately it is too much to expect that stockholders will, as they could and should, of their own initiative, require publication with the annual report of the list of each of the executives receiving compensation in excess of a certain amount.

DISCLOSURE OF THE SPREAD

The act requires disclosure in detail of facts relating to the spread, or difference between the amount paid by the investor

and the amount effectively available for the purposes of the enterprise. The registration statement must show:

(15) the estimated net proceeds to be derived from the security to be offered;

(16) the price at which it is proposed that the security shall be offered to the public or the method by which such price is computed and any variation therefrom at which any portion of such security is proposed to be offered to any person or classes of persons, other than the underwriters, naming them or specifying the class. A variation in price may be proposed prior to the date of the public offering of the security, but the Commission shall immediately be notified of such variation;

(17) all commissions or discounts paid or to be paid, directly or indirectly, by the issuer to the underwriters in respect of the sale of the security to be offered. Commissions shall include all cash, securities, contracts or anything else of value, paid, to be set aside, disposed of, or understandings with or for the benefit of any other persons in which any underwriter is interested, made in connection with the sale of such security. A commission paid or to be paid in connection with the sale of such security by a person in which the issuer has an interest or which is controlled or directed by, or under common control with, the issuer shall be deemed to have been paid by the issuer. Where any such commission is paid the amount of such commission paid to each underwriter shall be stated;

(18) the amount or estimated amounts, itemized in reasonable detail, of expenses, other than commissions specified in paragraph (17) of this schedule, incurred or borne by or for the account of the issuer in connection with the sale of the security to be offered or properly chargeable thereto, including legal, engineering, certification, authentication, and other charges.

PROFITS AND INTERESTS OF PROMOTERS AND OTHERS

Several clauses are calculated to ferret out the profits of promoters and others in a position to influence the transactions of the issuer. A disclosure by a promoter or director at a board meeting, or even at a stockholders meeting where more than ninety-five per cent of the representation is by proxy, of profits, because by reason of their fiduciary relationship they may not make secret profits, is a very different matter from a real publication of profits to stockholders. And a stockholder who is not a promoter or a director may be in a position to influence corporate action. It may be that if he did influence action, in the sense of not dealing at arm's length, an extension of equitable principles

might hold him to a responsibility for a disclosure of his profit. Though a stockholder as such is not in a fiduciary relationship to his fellows, still it would be just as well that they should know what benefits he derives from his dealings with the corporation, if his holdings are large enough to raise a suspicion that he might be able to influence the board of directors by reason of the extent of his ownership. Indeed, it is true of anyone who may for any reason be subject to suspicion of possible influence other than the bargain he offers. The act provides for a disclosure of:

(20) any amount paid within two years preceding the filing of the registration statement or intended to be paid to any promoter and the names of the principal underwriters of such security;

(21) the names and addresses of the vendors and the purchase price of any property, or good will, acquired or to be acquired, not in the ordinary course of business, which is to be defrayed in whole or in part from the proceeds of the security to be offered, the amount of any commission payable to any person in connection with such acquisition, and the name or names of such person or persons, together with any expense incurred or to be incurred in connection with such acquisition, including the cost of borrowing money to finance such acquisition;

(22) full particulars of the nature and extent of the interest, if any, of every director, principal executive officer, and of every stockholder holding more than 10 per centum of any class of stock or more than 10 per centum in the aggregate of the stock of the issuer, in any property acquired not in the ordinary course of business of the issuer, within two years preceding the filing of the registration statement or proposed to be acquired at such date.

The two-year period presumably was inserted to catch situations in which the party in interest is an influential stockholder during all the period of negotiations, but disposes of his interest before the date of the registration statement; and "any class of stock" covers a ten per cent voting power in a voting and non-voting share situation.

SIGNATURES REQUIRED ON THE REGISTRATION STATEMENT

The act requires that the registration statement be signed by the issuer, its principal executive officer or officers, its principal financial officer, its comptroller or principal accounting officer, and the majority of its board of directors or persons performing similar functions.

EFFECTS OF THE REGISTRATION STATEMENT

If A, holding in his hand an article, shows it to B and says, "I will sell you this article for $10," without saying more, A has made no representations of elements of value in the article. On effecting the sale, the law holds him to have impliedly warranted that he has a right to sell, and if later it appears that the object was a lost or stolen article, or otherwise A had no right to sell it, B can hold A responsible. But B cannot hold A responsible for any lack of value in the article. If, in addition to the statement indicated, A has said the article was once owned by Marie Antoinette, but B believed A to be lying, and therefore, though B bought, he did not buy because of a reliance on the additional statement, B cannot hold A responsible on ascertaining that the article had been manufactured two months before he bought and Marie Antoinette could not have owned it. In short, it is a general principle that a representation must have been made, it must be false, and the buyer must have relied on it, to enable the buyer to hold the seller responsible. The seller may believe his statement to be true — indeed may have exercised all diligence to ascertain its truth. That is not enough. The buyer has a right to rely on the statement, and if it is not in fact true, he can hold the seller responsible. At Common Law, failure to disclose a material fact is not a ground for either damages or rescission.

But the Federal Securities Act of 1933 goes beyond this. It can perhaps be justified on the ground that the nature of the securities business affects it with special responsibilities.

In effect, the act makes every statement of a material fact in the registration papers a representation to the buyer, whether it was ever actually communicated to him or not. Of course, if a statement was not communicated to him, he could not have relied on it. The act assumes communication as a presumption of law. To be sure, the act makes the records available, and even, as we shall see, requires a substantial part of their information to be included in a circular which must be furnished to the buyer. Nothing, however, compels the buyer to read the circular, much less rely on it. Yet the act provides:

Sec. 11 (a) In case any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or neces-

sary to make the statements therein not misleading, any person acquiring such security (unless it is proved that at the time of such acquisition he knew of such untruth or omission) may, either at law or in equity, in any court of competent jurisdiction, sue —

(1) every person who signed the registration statement;

(2) every person who was a director of (or person performing similar functions) or partner in, the issuer at the time of the filing of the part of the registration statement with respect to which his liability is asserted;

(3) every person who, with his consent, is named in the registration statement as being or about to become a director, person performing similar functions, or partner;

(4) every accountant, engineer, or appraiser, or any person whose profession gives authority to a statement made by him, who has with his consent been named as having prepared or certified any part of the registration statement, or as having prepared or certified any report or valuation which is used in connection with the registration statement, with respect to the statement in such registration statement, report, or valuation, which purports to have been prepared or certified by him;

(5) every underwriter with respect to such security.

Note that though the act requires only a majority of the directors to sign the statement, it makes all directors as responsible for the truth of the statement as those who sign.

Even though the investor did not rely on the statement, he has a right to sue under the act unless his failure to rely was due to knowledge of the untruth of the statement. He may not have thought the statement material, and it may not in the least have affected his judgment; he may not even have known of the statement; still apparently he can sue. This seems to turn a recovery into a penalty, rather than damages for breach of the warranty of a representation or for fraud.

Still the responsible person may have defenses. He can avoid liability, if he can sustain the burden of proof that

as regards any part of the registration statement not purporting to be made on the authority of an expert, and not purporting to be a copy of or extract from a report or valuation of an expert, and not purporting to be made on the authority of a public official document or statement, he had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading; ***

So, whether a recovery be regarded as damages or as a penalty, the act imposes a duty to be diligent, and, in this aspect, turns on negligence. The act does not create the warranty of a representation where none exists by reason of no communication. Essentially it puts the dealer in securities in a fiduciary relationship to the buyer, owing a duty to him of care in ascertaining and stating the facts. Is this a greater burden than the dealer ought to sustain?

Likewise an expert has a corresponding defense, if he can sustain the burden of proof that

> as regards any part of the registration statement purporting to be made upon his authority as an expert or purporting to be a copy of or extract from a report or valuation of himself as an expert, (i) he had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading, or (ii) such part of the registration statement did not fairly represent his statement as an expert or was not a fair copy of or extract from his report or valuation as an expert; ***

The only way a director can escape liability for a false or misleading statement is to resign before expiration of the twenty days after filing upon which the statement becomes "effective."

A registration statement is not in effect until the twentieth day after filing. Since the offense is the doing of any of the specified acts, unless a registration statement is in effect, the Federal statute holds up selling for this period, to give the Securities Commission an opportunity to consider the information filed.

All Blue Sky legislation faces a dilemma. If it permits transactions to be made before investigation, the damage is done for all who become buyers during the investigation period, and as to them a subsequent prohibition of sales is locking the barn door after the horse has been stolen; if the legislation prohibits transactions pending investigation it puts the dealer to the hazards of delay. The Federal act informs him that the delay will be for the definite period of twenty days, and so removes the uncertainty of those State acts which prohibit sales until express administrative consent is given.

But the Federal Securities and Exchange Commission can prevent the filing of the information from becoming effective by issuing an order suspending the registration until the statement

has been amended. And after the statement has become effective the Commission, on discovery that it contains an untrue statement, can, after fifteen days notice, issue an order suspending the registration. Such a suspension would be enormously damaging. The authority puts great power in the hands of the administrative body. It is susceptible of abuse.

PROSPECTUS

The act requires the publication of a prospectus containing the information presented in the registration statement, and provides in Section 5 (b) that

> It shall be unlawful for any person, directly or indirectly — (1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to carry or transmit any prospectus relating to any security registered under this title, unless such prospectus meets the requirements of Section 10; or (2) to carry or to cause to be carried through the mails or in interstate commerce any such security for the purpose of sale or for delivery after sale, unless accompanied or preceded by a prospectus that meets the requirements of Section 10.

Obviously the buyer has not relied on a prospectus which accompanies a security on its delivery after sale. Still an investor considering the purchase of a security knows that such a prospectus exists, and he need not purchase until it has been furnished to him. If he does not see the prospectus before purchase, its subsequent delivery to him enables him to see what information has been furnished, and if it is not correct he can, on suffering loss, enforce the statutory liability.

One may query if the statute does not have too many "teeth," and whether it has the proper number of wisdom teeth. Even though the investor buys blindly, not relying on any of the statements, he can nevertheless hold the seller who could have ascertained their falsity. Is not this too great a reversal of the doctrine of *caveat emptor?* And do we not need to encourage diligence on the part of the buyer as well as good faith and diligence on the part of the seller? Here the horse is led to water, and by the miraculous powers of the statute relieved from thirst without drinking. Yet the facts are peculiarly within the knowledge of the seller; that is, they are ascertainable by him and they are not, except through the statement of the seller, ascertainable by

the purchaser. The thing about this legislation that does violence to a sense of justice is that the buyer may recover even though, because he did not in fact rely, he was not in fact damaged. Yet anyone who has observed ordinary Common Law actions for misrepresentation, brought by investors who have suffered loss, can easily be suspicious of their allegations of reliance, and surmise that they may not have been aware of the false statement they are suing on until, after their loss, they began diligently searching the circular to see what they could find.

PENAL LIABILITY

Besides creating the special civil liability, the statute makes violations of the act a penal offense subject to fine up to $5000, and imprisonment up to five years.

SUMMARY OF PRINCIPLES

In the large capital contributor or loan groups of corporate enterprise, the individual stock- or bond-holder cannot practicably exercise on his own behalf those cautions which he would fail to exercise at his recognized peril if he were the sole contributor or lender. No one would buy the premises for a store, or lend $5000 on a house and lot, without investigation of title. If a man should buy a drug store business without an inventory and appraisal of the stock, and an audit of the books, he would be an object for the ridicule and pity of the experienced on ascertaining that the business was not as was represented.

Buyers of a few shares of stock or a few bonds of an issue of many millions of dollars cannot do these things for themselves, and cannot pay the costs of having them done. Even if the expense were not prohibitive they would not be allowed the opportunity to make an adequate investigation of assets, or an audit of accounts, as a condition precedent to investing. If they are to invest at all in such large group transactions, they must rely on others.

Yet, when buying from an investment banker, an investor deals with a seller who has interests adverse to those of the buyer. Our Common Law had not adequately developed the relationship as different from that of ordinary buyer and seller, when the buyer, if diligent, was able to protect himself. The

situation is outside of those relationships in which the Common Law finds a fiduciary character. The banker is not an agent of the investor, and our social thought, as far as the Common Law expressed it, has not made him responsible to the investor for diligence. The banker was responsible to the investor for his representations, as any seller is responsible to his buyer.

As pointed out in the chapter on State regulation of the sale of securities, no seller has heretofore been liable for misrepresentation unless the buyer relied on it. If the seller does not know of a statement, there cannot be even a representation, to say nothing of reliance. The Federal Securities Act of 1933 attacks the problem of the necessary reliance of the investor on the banker by requiring that certain statements be made, by extending the idea of representation to include any statement as a representation, whether known or not to the investor, and by imposing liability without any reliance.

With respect to experts making reports to the bankers, the act goes further and creates a relationship between the expert and the investor. As far as representation goes, the banker makes no misrepresentation in presenting an expert's erroneous report, for all the banker says is that the expert has so reported, and that statement is true. But the expert knows that his report will be used to influence the investor, and any honest man as an expert feels the moral burden of responsibility to those with whom he is not in direct relationship, but who, he knows, may rely on his statements.

The act, properly enough, does not impose on him the degree of responsibility of a vendor for representations, but a duty of diligence and good faith. The expert is liable to the investor for his report unless the expert can sustain the burden of proof that "he had, after reasonable investigation, reasonable ground to believe *** that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading."

The Securities Act of 1933 recognizes the proper responsibility of the seller for the reports of experts he presents. As far as representation is involved, the sole fact is that the expert did make the report. But the act makes the banker responsible for the truth of the expert's report. This would be intolerable if he had to make the whole of the report a representation by himself.

But the act permits him to relieve himself of responsibility, just as the expert himself may do, if the banker can sustain the same burden of proof that he "had reasonable grounds to believe and did believe that the statements were true."

In short, here is, not an absolute liability for the truth of statements, but a duty of diligence and good faith. One hopes, and indeed expects, that the courts will interpret "reasonable grounds" as satisfied by diligence in selecting experts, to see that they satisfy the requirements of training and experience to qualify as expert, and that they have a reputation for being honorable. One cannot altogether object to an essential reversing of the usual rule of law that the party plaintiff has the burden of proof: indeed, the act carries out the usual principle to the extent of leaving the burden on the plaintiff to prove falsity, but once that is established the act shifts the burden. The real cause of action is the lack of diligence or good faith on the part of the defendant. Yet the facts for the defense are in the knowledge of the defendant; the failure of those facts is not in the knowledge of the plaintiff. So the rule of the act seems not unjust.

The reader will find a more detailed consideration of the Federal Securities Act of 1933 in Chapter XLVIII. Some respects in which the Federal Securities and Exchange Acts affect the operation of the law will appear there.

CHAPTER XXXII

Organization of Syndicates

Several times in the chapters about buying issues of securities we mentioned the formation of syndicates. Business processes develop various ways of distributing risks. For example, manufacturers may sell to jobbers, who sell to retailers, who complete the marketing by sale to the consumer. With each step the risk of carrying the goods passes to a larger number of risk bearers. It is true that each group also performs a service function. Risk and service, however, are distinct functions, and in practice could be separated. In the marketing of tangible things the manufacturer or the jobber might deliver "on consignment"; in that event the jobber or the retailer, as the case might be, would continue to fulfil the same service function, but would not assume the risks of ownership.

LEGAL NATURE OF A SYNDICATE

Investment bankers have developed the syndicate as a device for distributing the risks of the marketing process, and for performing the service of selling. We have another example of group organization in the field of corporation finance. Fundamentally, a syndicate is a partnership, not for the purpose of carrying on a continuous business, a series of transactions, but to carry through a single undertaking on the completion of which the partnership dissolves. Such a specialized form of partnership the terminology of the law calls a joint venture.

We have followed the process of an investment banking house in contracting to buy an issue of securities. Let us assume that the bankers feel confident that the representations of fact stated in the conditional commitment letter will be verified. While negotiations leading up to the delivery of this letter were going on, the bankers discussed the proposed business with several

other houses. These houses have joined our bankers, Robinson, Brown and Company, in marketing previously; and from time to time Robinson, Brown and Company have joined in marketing issues initiated by some of the other houses.

Robinson, Brown and Company are initiating, or originating, to adopt the word more commonly used, the issue of Utilities Manufacturing Corporation. This banking house has the contact with the issuer, and is spending time in carrying on negotiations for the purchase of the proposed issue. If a commitment is made this house will initiate and follow through the investigations to verify the representations. The piece of business is its business.

CUSTOM OF EXCLUSIVE NEGOTIATION

If the officers of the corporation are well informed, they will not try to carry on competitive negotiations. In our description of the course of the business, we had it proceed directly to a conclusion. If it had hung fire at any point, the corporation officers would have been under a strong temptation to start negotiating with some other banking house while Robinson, Brown and Company were still considering the issue, and to close with the house which first came to acceptable terms. But the ethics of the investment banking business are such that no other house may with propriety consider the business while Robinson, Brown and Company have it under consideration.

This custom is not at all essentially for the purpose of establishing a tacitly monopolistic situation. Preliminary investigations consume time and often cause considerable expense. The house does not want to negotiate at all, unless it can feel that, if it decides it wants the business and offers fair terms, it will secure the issue. Nevertheless, if for any cause, reasonable or not, the corporation breaks off negotiations with Robinson, Brown and Company, withdraws the proposal from that house, the customs of the business do not prevent any other from taking it up.

An even more important reason than not wasting time lies back of the custom. It keeps negotiations from getting tangled and protects the corporation as well as the bankers. Assume that Robinson, Brown and Company understood that they had the business in hand; that, in effect, in accordance with the custom, the corporation was undertaking to deal only with them in consideration of their going forward with negotiations until

either a commitment was made, or the corporations withdrew from the negotiations, or the bankers terminated them. So understanding the situation, Robinson, Brown and Company take up with another house the matter of an association in marketing the issue. But the important corporate officers have already started negotiations with the other house, which has come to a decision, without yet closing with the corporation, that it wants to originate the issue itself. Since the matter has come to it directly from the corporation, it feels free to close, and does so.

Robinson, Brown and Company may feel that they have a claim against the corporation for breach of a contract amounting to an option on the business, or a claim against the other house for inducing a breach of contract. Of course the facts may not substantiate either claim, but Robinson, Brown and Company may not know all the facts and may believe that they have a claim. It is far better to have a custom of business which avoids the possibility of such a feeling.

If the representatives of the corporation, while negotiating with one house, do begin negotiating with another, they are likely to find themselves dropped by both. The number of originating houses is not great. It is highly probable that one will hear of negotiations with another. Each, believing that it has in hand the original negotiations with the corporation, is likely to approach the other as a possible associate in the business. Then the situation will certainly appear. And the Street is a good deal of a whispering gallery. Almost anything is likely to become generally known.

For corresponding reasons a banking house endeavors to make certain that anyone approaching it with a matter of financing has authority from the prospective issuer. In our illustration of the corporate officers representing the corporation the question would not arise, excepting perhaps an inquiry as to how far ultimately necessary directors' and stockholders' action had gone. But men of the type who think themselves "clever" constantly try to squeeze a commission out of a situation (not only in finance, but in any field) by representing themselves as having authority, or leaving the inference to be drawn from their conduct, then going to the people of the other side of the possible transaction and procuring actual authority on the strength of their representations of what they can accomplish. Sometimes the strategy succeeds.

Men who have not had experience in finance are likely to feel that someone with "influence" can accomplish for them what they could not do for themselves. They are naturally susceptible to the suggestions of the clever individual on the hunt for a commission. But the magnitude of the transaction of an original issue of securities, and the risks involved, are too great to permit influence to take the place of judgment; and, as far as influence is concerned, those who want the assistance of a banking house had better immediately come face to face with the bankers, with the advantage in time and clarity of direct negotiations. Experienced business men know these things; but not the multitudes of the inexperienced, who erroneously think of Wall Street as the place where the fountains of money flow, for those who can gain admission, to finance entirely promotional enterprises with no earnings.

All this does not say that a third party can never be of advantage. An experienced man knows how to assemble and present the facts so as to be readily understood. He knows what is fair, what is customary in bargaining in finance. He may get better terms for the issuer than it would get for itself; he may prevent the issuer from rejecting as good terms from one house as could be obtained from any house. Such a man knows that he should come from one side to the other with certain authority, and that the terms of his compensation should be clearly understood before he enters into any negotiations. It is seldom that his employment will come from the banking house.

We got off on this digression about negotiations because our banking house approached other houses on the business before committing itself to purchase the issue. In so doing, our house got the reaction of other bankers as to the possibility of marketing the issue, and, finding this favorable, assured itself that it could have associates in the transaction. On coming itself to a conclusion that the issue would be a good one for it to originate, it signed and delivered the commitment letter, and procured the acceptance of the corporation.

Now that our bankers have definitely bound the business to themselves, so that the corporation officers are no longer free to withdraw it from their consideration; and now that they are also certainly under the risk, they proceed to get their prospective associates bound in a syndicate agreement. Our banking house has undertaken to buy the securities from the corporation. The

syndicate will undertake to buy the issue from our bankers. A further syndicate may be formed to buy it from the first syndicate.

SYNDICATE TO PURCHASE FROM CORPORATION — JOINT ACCOUNTS

We should note also that our bankers, instead of acting for their sole account in undertaking to purchase the bonds from the corporation, might first have organized a syndicate, and entered into the agreement with the corporation on behalf of the group. If only one other house joined in the purchase, the transaction would be called a "joint account." The house carrying on the negotiations with the corporation and inviting the other house to join it in the purchase might stipulate for special compensation for its services in originating the business, as one half of one per cent on the face amount of the issue.

Language of the Street does not always use a precise terminology, and sometimes applies the phrase "joint account" to a syndicate of more than two. And it is not confined to the purchase from the corporation, but may apply to any small syndicate. Strictly, it should be used only when there are two participants and no more. Since the bankers, in our case, were satisfied that they would succeed in forming a syndicate to take over the risk, they went ahead and made their sole commitment to the purchase. By having the business in this way firmly in their own hands, they are in a position to claim and take a special profit as originators.

MORE THAN ONE SYNDICATE

For our illustration of the formation and operation of syndicates, we will assume the formation of two successive syndicates for the complete process of assumption of risk and marketing the issue. The group of the first syndicate is much smaller in number of members than the second group. Members of a syndicate group are called "participants" and the interest of each in the syndicate a "participation."

ORIGINATOR, AS SYNDICATE MANAGER, RETAINS CONTROL THROUGHOUT

Regularly the house originating the issue forms each syndicate and becomes its manager. Also it takes a participation in each

syndicate. Through its position of originator, of organizer and manager of the syndicate, it controls the entire marketing of the issue. It participates in each syndicate for two reasons. By continuing to share in the risk it shows its faith in the issue. It invites the other houses to become partners with it in the business instead of taking the position of a seller with an interest adverse to the buyer. Also it seeks the additional profit to be gained as a participant.

FIDUCIARY RELATIONSHIP OF ORGANIZER OF SYNDICATE

By inviting the other houses into partnership, our banking house gets into a position very different from that it would be in if it asked them to form their own partnership, leaving it out, to buy the issue. In the latter case it could deal at arm's length. It would not be bound to make any disclosures. It could state such of the facts as it saw fit, and not state others. It need not say whether or not it is making a profit. But on becoming a member of the syndicate partnership, the house enters into a fiduciary relationship with its co-partners.

In the adverse seller and buyer relationship, it is as if the seller said, "I am out to get the best price possible without lying, and shall say or imply no more than I choose. You, the buyer, knowing this, conduct yourself with the caution the situation calls for. You can ask me any questions you see fit. If I answer them with anything but the fact, even though I believe what I say is the fact, I shall be answerable in damages for my misrepresentation. If I do not answer your questions you, of course, need not buy. But do not make assumptions that I, by my words or conduct, have not caused you to make." In effect this is the often maligned *caveat emptor* doctrine.

An invitation into a partnership is another matter. It is as if the person extending the invitation said, "I am asking you to join me in an enterprise for our mutual benefit. In the enterprise I am your friend and I expect you to be mine. I will tell you everything I know about the matter, and I expect you to deal with me in like manner. We will share, in accordance with our agreement for sharing, in all advantages to be gained from the business from beginning to end. You need not be on your guard in dealing with me. I have a right to assume that I need not be on my guard in dealing with you."

So the house which organizes a syndicate of which it becomes a member may not make a secret profit. Co-members have a right to assume that it has not made any such profit. If the organizing house does not disclose, to the houses it induces to participate, the fact that it owns or has contracted to buy the securities it is selling to the syndicate, and does not disclose that the sale by it is at an advance in price, the other members of the syndicate can compel it to turn its profit into the syndicate.

Presumably the organizing house has no duty to tell its co-participants how much profit it is making, if it tells the fact that it is making a profit, and they are willing to join the syndicate without ascertaining how much. Query: whether having joined the syndicate without having ascertained the amount of the profit, when they know a profit was taken, they have a right subsequently to know the amount. And query further: whether they have a right to assume that the profit was an ordinary normal amount for transactions of the kind.

Without delaying to attempt an answer to these questions, we will remark simply that the originator states in the formal syndicate agreement that it is making a profit on its own account, without stating the amount. Probably the participants in the smaller syndicate groups do know the amount. Since at least the originator, and generally all or most of the other members of a syndicate, become participants of the next subsequent syndicate, a corresponding disclosure is made of the fact of a profit.

PURCHASE GROUP

The first syndicate will have only a few participants — let us say in our instance, four. The agreement will state that it is the intention of the originating house to organize a further syndicate to buy the issue from the syndicate now being formed. If there were to be a syndicate between the purchase group and the final syndicate marketing the issue, the intermediate syndicate might be called the "bankers group." We again find a lack of precision in the use of this word "group." As we shall see later, it is also used to indicate a situation in which a group is formed solely for selling without the assumption of any liability. In connection with the marketing of securities it might be well to reserve the word "group" for use in this sense of joining in a selling agreement without liability to take up any part of the issue.

FORM OF SYNDICATE AGREEMENTS

Whether the number of participants in a syndicate is large or small, the agreement they enter into regularly takes the form of a letter from the house originating the issue containing the terms of the proposal. This letter, stating the amount of the participation to be taken, is signed in duplicate by the originating house, which forwards both copies. The house to which it is addressed signs an acceptance below the signature of the originator, to which the participant returns one of the duplicate originals. This form of evidencing the agreement is the same as that we have seen in the conditional commitment letter, by which the originating house contracted to buy the issue from the corporation.

Investment bankers have reduced their agreements to the most direct forms. A letter making an offer complete in every necessary matter, and an unqualified acceptance of the offer, form a contract. When delivered in duplicate, each party retaining a copy, the evidence is established in the simplest possible way. For experienced people, aware that they are assuming liabilities, this is a desirable way of doing business. Inexperienced people may not appreciate the importance of what is contained in the familiar form of a letter. The unfamiliar appearance of a more formal legal instrument may impress on the less experienced the fact that its contents have a serious importance.

The agreement of our first syndicate might run somewhat as follows:

To Smith, Jones and Company,

Dear Sirs:

We are forming a bankers' syndicate, of which we will be the managers and in which we will participate, to purchase in an undivided account, from ourselves, when, as, and if issued and received by us, at 91 and accrued interest, at which price we make a profit, $10,000,000 five per cent First Mortgage Sinking Fund Bonds due November 1, 1960, of Utilities Manufacturing Corporation. These bonds are more fully described in a memorandum annexed hereto. We intend to form a selling syndicate to purchase these bonds from the bankers' syndicate at 92 and accrued interest. The liability of the bankers' syndicate will continue until all the bonds are sold or taken up by the selling syndicate. It is our intention to arrange for a loan on behalf of the bankers' syndicate or the selling syndicate to take up these bonds from ourselves and carry them

while they are being distributed. Your participation in the bankers' syndicate may be pledged as collateral for such a loan.

We offer you a participation of $2,500,000 in this bankers' syndicate.

Very truly yours,

ROBINSON, BROWN AND COMPANY
By S. R. Brown
(one of the partners)

Accepted
SMITH, JONES AND COMPANY
By A. B. Smith
(one of the partners)

Most of the terms of this agreement have already been sufficiently considered to have their significance appear. We will consider later the phrase "undivided account." The agreement might provide that this syndicate should bear some part of the costs of originating the business, and might contain other terms to fit a particular situation. It does not contain the terms which will be necessary in the selling syndicate agreement to regulate the operation of a selling account. We have still to consider the provisions of such an agreement. It will be noted that the letter calls for the attachment of a memorandum setting forth a fuller description of the security. This assumes that the work on the issue has not yet progressed to the point of a printed circular. If it has, the circular would be attached instead of a memorandum. Very likely in the future the complete prospectus called for by the Federal Securities Act of 1933 will be used where a circular has heretofore been used. Practices under the act are still in the process of development.

It is not intended that this intermediate syndicate will do any part of the work of selling to investors. The syndicate is only to divide the risk, and its compensation is solely for the risk assumption. As we have formulated the transaction, Robinson, Brown and Company remain fully liable to Utilities Manufacturing Corporation to take up and pay for $10,000,000 face amount of bonds. But on the formation of this syndicate they have a right to call on it to take up and pay for the issue. If Robinson, Brown and Company take for themselves a participation of $2,500,000, they will have their primary liability reduced to one-quarter of the original amount, but they will remain liable to the issuer for the other three-quarters.

UNDIVIDED OR UNLIMITED LIABILITY SYNDICATES

The phrase "undivided account" was not necessary in the syndicate letter presented above. Unless stated to the contrary, the account would be undivided. But the other type of account is so common that it is desirable for the sake of avoiding any possible misunderstanding to say that the account is divided.

We have already seen that a syndicate is essentially a partnership. Whatever the agreement of the partners among themselves for sharing losses, each partner is fully responsible to third parties for all partnership liabilities. Only an expressed agreement with a third party could relieve the partner of the full liability. If there were four equal participations in the syndicate, and Smith, Jones and Company should become unable to honor a dollar of their responsibility, Robinson, Brown and Company would have the right to call upon each of the other participants to take up a full third instead of only a quarter of the issue (assuming that no subsequent syndicate was formed to take up the bonds). Here the parties have agreed (by taking equal participations) to share losses equally. The solvent associates of Robinson, Brown and Company do not assume any less liability than the managers assume.

DIVIDED OR LIMITED LIABILITY SYNDICATES

Since it is expected that a further syndicate will be organized to take over the bonds and do the work of selling, the number of participants is small. Presumably they are well known to each other. They do not attempt any special variation of the partnership rule of liability. Robinson, Brown and Company play a dual rôle. They are selling the issue to the syndicate and are one of the members of the syndicate buying the issue. Since they disclose to their buying associates that they are the seller, and are making a profit in the transaction, they may act in both capacities. On the selling side, however, they become completely disassociated, and have a right to hold their fellow members to the same liability they would have if the syndicate were buying the issue from someone not a participant.

Until probably about the beginning of this century no attempt was made, or, at least, was not commonly made, to vary the general partnership rule of liability, even in selling syndicates.

Such a syndicate, however, necessarily fulfils two functions, carrying risk and doing the labor of selling. One participant may readily do more than its share of labor; i.e., it may have a participation of, say, $100,000 but sell $200,000 of the bonds. On the theory of the partnership, they not only have no right to any additional compensation for doing work beyond the proportion of their share in the partnership enterprise, but even are obliged to do all they can. Each partner must exert his best energies for the success of the common undertaking.

All this doctrine of utmost endeavor serves very well for the usual partnership of from two to half a dozen intimately known to each other, and each able to see whether the other exerts himself. When the number of those in the group runs beyond this, and up to perhaps two hundred, the principle may not work so well. For a securities syndicate the originator forms the group by inviting other houses to join. The originating house does not tell each of the other houses who else has been invited, does not tell who have accepted.

Very likely each knows who some of its associates are, but does not know the large majority. If a house with a participation of $100,000 sells $200,000, but the syndicate as a whole sells only $5,000,000 of a $10,000,000 issue, the house which has sold more than the amount of its participation may very well feel aggrieved when it is called upon to take $50,000 more bonds. We should always remember that the participation in an undivided, or unlimited liability, syndicate only measures the amount of the interest of the participants in the enterprise as a whole, and shows the proportions in which they have agreed to share profits and losses.

It is the part of caution for the individual assuming liability to seek to limit it, to know as nearly as he can where he stands. This desire led men to the device of the corporate form of business. The interest of the debtor conflicts with the interest of the creditor. But if the limitation is contracted for, each knows where he stands. In the syndicate problem, however, the limitation does not have the same social interest. The syndicate partnership presumably remains unlimitedly liable to those with whom the syndicate deals. The limitation sought is only as to the manner in which the partners will share the whole risk of the partnership.

So the divided account has been developed in syndicate transactions. In many syndicates there is still no special agreement of

the participants for varying among themselves the general partnership rule. But probably the large majority in number of selling syndicates (if not in the amount of securities) now contain such a special agreement. Some of the largest of the originating houses have adhered to the older form, and their influence is such that participants in the syndicate they organize accept it.

In a divided account it is agreed that a participant who has sold securities up to the full amount of his participation shall not have any further liability to other members of the syndicate. A participant who has sold less than the amount of his participation may be called on to take up securities up to the amount of his participation.

UNSOLD SECURITIES DISTRIBUTED TO PARTICIPANTS ON DISSOLUTION OF SYNDICATE

When the time arrives for the termination of a syndicate, the practice is to call on participants to take up their proper pro rata of the unsold securities. The syndicate seldom cuts the price to enable it to dispose of an unsold part of an issue. So, broadly speaking, a syndicate does not suffer cash losses. However unsuccessful, it shows some cash profit. The unsuccessful syndicate closes its affairs by a distribution in kind. A participant who is not yet out of his liability to the syndicate must pay for and take up to hold for his own account his share of the amount unsold.

PROBLEM OF PARTICIPANT UNABLE TO TAKE UP HIS SHARE

But what if a participant does not have the ability to take up his share of the unsold securities? In the undivided account, each of the other participants has to shoulder his share of the burden of the disabled one. If the account is of the divided kind, however, the agreement provides that no one can be called on to take up more than the amount of his participation. Some of the participants may have sold enough more than the amount of their participations so that the solvent ones of those who have sold less can be called on to take up the amount which the insolvent should take up.

In case no one has oversold, however, who will take up the share of the insolvent in default on his syndicate obligation? The par-

ticipation agreement of the syndicate manager, who originated the business, limits his liability to other members just as each of their agreements limits their liability. The agreements are merely counterparts, and the situation is the same as if all the participants had signed one paper.

Very likely as a matter of legal right the bank which has made the syndicate loan, and holds the unsold securities and the syndicate agreements as collateral, could hold each participant responsible for the unrepaid part of the loan. Their agreement as to each other perhaps would not limit their liability to the bank even though it is on notice of the limitation. The limitation could be interpreted as an agreement *inter sese* even though it were stipulated that the entire participation agreement might be used as collateral. Correspondingly it would be the right of the manager to hold his co-participants to take up the unsold balance of a defaulting member. The usual form of syndicate agreement might well be improved by express contractual statement clarifying the situation.

DURATION OF SYNDICATE

A syndicate is a joint venture undertaken for the purchase and sale of an issue of securities. Unless stipulated to the contrary, it would continue until the completion of its purpose. Syndicate agreements, however, regularly provide that the venture shall be joint only for a limited period of time. After that the group dissolves and each member takes on his own account his share of the unsold securities. He must then get out of his risk for himself as best he can. Often the agreement authorizes the manager to extend the period. A governing clause might be: "This syndicate shall terminate January 15, 1935, except that the manager shall have the right to extend its duration for two further periods not to exceed thirty days each."

It is interesting to note that the rules under the Code of Fair Practice provide (Art. V, Sec. 10): "If provision is made in any selling syndicate agreement for the extension of the original period of the selling syndicate, such extension shall only become effective upon the consent of participants in the selling syndicate representing seventy-five per cent interest of the selling syndicate." Presumably this is intended to cover only agreements permitting the manager to extend the time without express limitation on the extension. With an agreement containing such a clause as that

indicated in the preceding paragraph, the manager already has unanimous consent for a definite period of extension. The extension clause might be general, as that: "The manager shall have the right to extend the duration of the syndicate for a further period or periods upon the consent of participants representing seventy-five per cent interest therein."

Participants do not want to hazard their fortunes indefinitely to the group action. They want to be able to look forward to settling their affairs on their own judgment, to being free to reduce the price, liquidate and take their loss if they wish, or to hold their share of the unsold securities in hope of better market conditions.

SYNDICATE SELLING PRICE

Maintenance of a uniform selling price is of the very essence of a syndicate transaction. Such a price agreement does not contravene any anti-monopoly laws. Any seller has a right to name his price and stick to it. The syndicate sells as a group. It is a business unit just as much as one man who might own an issue and offer bonds for sale. Each participant is only an agent for the group. He is bound by his authority from his principal, the syndicate partnership, and liable to it for exceeding his authority. Whether it could repudiate a purported sale at less than the syndicate price on the ground of lack of authority in the agent presents another question.

Partners are general agents of a partnership. The syndicate operation is a joint venture. Though the principles of partnership generally apply, and for the sake of simplicity we have spoken of it as a partnership, its special purpose may, perhaps, to some extent vary the governing principles. Are investors generally aware of the limitation on the participant's authority to name a price? We will not attempt to answer the questions raised, but will confine our consideration to the importance of the uniform price. We shall see how much of the contents of a selling syndicate agreement relate to price maintenance.

SELLING SYNDICATE AGREEMENT

A selling syndicate agreement presents a complete chart of the course of the primary market in securities. Let us examine

such an agreement before considering its provisions further. It will take up a hypothetical transaction:

UTILITIES MANUFACTURING CORPORATION FIRST MORTGAGE FIVE PER CENT SINKING FUND BONDS DUE NOVEMBER 1, 1960
SYNDICATE

225 Wall Street, New York City
October 25, 1935

To Thompson, Hollister and Company
647 Broad Street
New York, N.Y.

Dear Sirs:

We and our associates in a bankers' syndicate have agreed to purchase from us, when, as, and if issued, and subject to the approval of counsel, \$10,000,000 face amount of the First Mortgage Five Per Cent Sinking Fund Bonds due November 1, 1960, of Utilities Manufacturing Corporation, a corporation of the State of Delaware. For further facts about the issue we submit to you the enclosed circular.

We and our associates are now forming a distributing syndicate, of which we are the managers, and in which we and our associates are participating, to purchase, when, as, and if issued and received by us and by the bankers' syndicate, the entire issue of \$10,000,000 of such bonds at 92 and accrued interest, at which price we and the bankers' syndicate will make a profit.

The distributing syndicate will offer the bonds for sale at 95 and accrued interest. A selling commission of 1 per cent will be allowed the participant on all sales confirmed by the manager. Of this selling commission a participant may allow a commission of $\frac{1}{4}$ per cent to investment bankers. On all sales confirmed in excess of the full amount of a participation an additional oversales commission of $\frac{1}{2}$ per cent will be allowed, and will be charged in proportion to undersales, against participants whose confirmed sales are less than the full amount of their participations.

The managers reserve the right to change at any time the selling price and/or commissions.

No charge will be made by the manager or its associates for forming the syndicate, or by the manager for managing the syndicate.

The maximum liability of a participant will be for the amount of bonds stated in the participation at the net cost to the syndicate, including cost of advertising, printing, mailing, telegrams, cables, legal and other expenses properly chargeable to the syndicate, and any participant

who effects sales equal to the entire amount of his participation will be under no further liability, except as hereinafter provided on account of bonds sold by the participant and repurchased for the syndicate account by the manager.

Members may withdraw bonds to an amount not exceeding their participations upon notification to the manager on or before November 5, 1935, on payment by them at the syndicate cost price of 92 and accrued interest plus $\frac{1}{2}$ per cent in lieu of the amount of syndicate expense allocatable to the bonds withdrawn. A member withdrawing bonds shall not sell or contract to sell such bonds during the term of the syndicate.

On notice to the manager at the time of acceptance of a participation a participant may have bonds firm for immediate sale to any amount equal to the full amount of the participation, and may subscribe, subject to allotment in the absolute discretion of the manager, for an amount in excess of the full amount of the participation.

Duration of this syndicate shall be until December 15, 1935, unless sooner terminated by the syndicate manager on the sale of the entire issue, or unless extended by the manager for a period or periods, which may not, however, exceed, in the aggregate, sixty days.

The manager may, in its sole discretion, release any member for any cause on substitution of another satisfactory to the manager.

In case of default on the part of any member, his interest in the syndicate may be sold at public or private sale, with or without notice, and the manager, or any other member or members, may be the purchaser or purchasers of the whole or any part; but, notwithstanding, every such defaulting member shall be responsible to the extent of his full liability under this agreement. The manager may, however, in its sole discretion, make any adjustments with such member as it may deem proper. A default by one member shall in no way release any other member from such member's full liability hereunder.

After acceptance of participation, but not earlier than the time fixed by the manager for public offering, of which notice will be given by the manager, members may begin selling. But all sales shall be made "when, as, and if issued and received and subject to confirmation," and reported at once to the manager. Members shall not sell against their participations unless, and to the extent that, the participations are taken firm, but only subject to confirmation from the manager. When members report sales by telegram or telephone and confirm by mail, the letter of confirmation should definitely state that it is in confirmation of sales reported by wire.

Members will be notified of the time delivery will be made, at 95 and accrued interest, at the office of the manager, Robinson, Brown and Com-

pany, 225 Wall Street, New York City, New York, to all members on payment in New York funds.

It is the intent of the manager to arrange a loan or loans to carry the bonds for the members, unless a member shall request to carry his own participation, but the manager reserves the right to call on the members each to take up and carry the members' pro rata share of unsold bonds at any time. Bonds so taken up prior to the termination of the syndicate shall be held subject to the call of the manager, and subject to all the provisions of the syndicate agreement.

The manager may make a loan or loans for the benefit of the syndicate, and may pledge either or both syndicate securities and the participation agreements of the members as collateral for loans to carry such securities, whether made to the manager individually or to the syndicate.

On prompt application members will be supplied in reasonable quantity with circulars bearing their own imprint which should be furnished with the application. Members are not to use circulars other than in the syndicate form. No circular shall be mailed, delivered, or otherwise shown earlier than the public offering day. No advertisement shall be published until it has been approved by the manager. All circulars mailed or sent out and all advertisements inserted by the several members shall be at their own expense, and likewise all cost of their communications to the manager.

The manager shall have the right to purchase for the syndicate account any bonds of this issue which may be offered in the market during the term of the syndicate at or below the public offering price, and may require a participant to repurchase at cost to the syndicate such bonds sold by or through the participant; or the manager may, in its discretion, withhold from the participant the selling commissions due on such bonds.

The manager may in its discretion purchase and sell, either on long or short account, bonds of this issue for the syndicate in such amounts and at such prices as it may deem desirable, except that the commitment in such trading, either for long or short account, shall not at any one time exceed fifteen per cent of the amount of the issue.

We are not under any obligation to take up the issue from the corporation unless and until registration with the Federal Government is effective and the securities are qualified for sale in Massachusetts, New York, New Jersey, Pennsylvania, Michigan, Ohio, and Illinois. In the event of the bonds being taken up by us, the participant will be released from his participation and a substituted participation provided (which may be an additional participation by the manager) if registration with the Federal Government does not become effective, and if the security fails to qualify in whichever of the above States the participant has his principal

office. Registration of the issue with the Federal Government is now effective, the required State Notice duly filed in the State of New York, and the issue has been qualified in the States of New Jersey, Pennsylvania, and Illinois. Applications are pending in Ohio and Michigan.

We have reserved for you in the above syndicate a participation of $250,000 in face amount of the said bonds. This participation is offered to you for your own account and is not to be reoffered, or assigned, in whole or in any part. Please advise us whether or not you desire to accept this participation, and if you accept, the amount of bonds you desire to have firm or to subscribe for. All acceptances, subscriptions, or reservations of firm bonds must be received by us by letter or telegram not later than October 28, 1935.

Robinson, Brown and Company
Syndicate Managers
225 Wall Street, New York, N.Y.

To Robinson, Brown & Company
Syndicate Manager

The undersigned hereby accepts the participation specified in the above communication upon the terms and conditions set forth, requires $50,000 bonds firm, and subscribes for no additional bonds; and requests 500 circulars bearing imprint enclosed herewith.

Thompson, Hollister and Company
by C. D. Hollister
(one of the partners)
647 Broad Street
New York, N.Y.

Such a letter is presented to bring all together the general aspects of a syndicate transaction. It is susceptible to much variation. A draft for an actual syndicate may be prepared only on knowledge of the stage of the transaction for the purchase of the issue from the corporation, the stage of compliance with Federal and State regulation, and all other conditions under which the bankers are working. We will defer to the next chapter, on the operation of the syndicate, consideration of many of the terms of the agreement.

TAXATION AS AFFECTING FORM OF SYNDICATE TRANSACTION

Forms of syndicate agreements presented have provided for a purchase of the issue from the corporation by the originating house, purchase from the originating house by the bankers'

syndicate, and purchase from the bankers' syndicate by the selling syndicate. At the time of writing, the Federal Government (Schedule A–9 of Title VIII of Revenue Act of 1926 as added by Section 724 (a) of the Revenue Act of 1932) imposes on the sale or other transfer of title to bonds a tax of four cents on each $100 in face amount. The act (Schedule A–1) also imposes a tax of ten cents on each $100 in face amount of bonds issued by a corporation. Presumably the original issue by the corporation to the originating house would not be subject also to the tax on transfers. The original issue tax must be paid and stamps evidencing it in the amount of $10,000 affixed as required. But the transfers to the bankers' syndicate and to the selling syndicate would demand two transfer taxes, which on a $10,000,000 issue would amount to $4000 each, an aggregate of $8000.

Instead of making a commitment to buy the bonds from the corporation, the originator might have agreed to form a selling syndicate to buy them. And the bankers' syndicate, instead of agreeing to buy the bonds, might have agreed with the originator to organize the selling syndicate for a commission of one per cent. Such a form for the marketing transaction would seem to eliminate the intermediate transfers.

Of course every sale by the selling syndicate to investors would require the payment of a tax which on the aggregate of the sales would amount to $4000. Conceivably the bonds might be marketed by having the corporation itself make the public offerings to investors which the bankers would underwrite, that is, agree to take up any bonds not taken up by investors on the public offering, still further reducing the tax. But conducting a selling campaign as agents of the corporation is not in accord with the nature of American investment banking business.

This Federal bond sales tax expires by statutory limitation July 1, 1939, and unless Congress extends the time, will no longer present the problem. It has been discussed simply to show that those who are formulating the primary marketing transaction must ascertain all the conditions governing at the time. It is unfortunate that so much taxation depends on the form in which business is done. But counsel who did not pay careful attention to form would be criticized for penalizing his clients.

sale of an issue of securities wants to know that the originator is organizing and will control the marketing.

An originator could grant freedom from liability by separately appointing each dealer a selling agent. Such an appointment, however, does not assure the dealer that other agents are bound to sell at the uniform price, and otherwise to work on the same terms and under the same conditions. Formation of a selling group constitutes a joint venture partnership for the purpose of performing the service of selling securities of the issue.

Our bankers' syndicate assumed risk and got out of the primary risk on the organization of the selling syndicate. This second syndicate group assumed the primary risk and expects to get out of it by selling the bonds to investors. There is both the assumption of risk and the performance of work. A selling group performs work without assuming risk. But its members render their service as partners under obligation to each other to abide by the partnership agreement.

SELLING AGENTS

Sometimes a dealer, unwilling to assume the risks of a participation in a syndicate, may become an agent authorized to sell bonds of the syndicate issue for the compensation of a commission on his sales. Since the syndicate owns and is selling the issue, such a dealer is an agent of the syndicate. Authority of the manager to appoint such agents, if desired, should expressly appear in the syndicate agreement. The appointment should bind the agent to all the rules of the syndicate.

CHAPTER XXXIII

Operation of Syndicates

Invitations to participate in the syndicate have gone out, and acceptances have been received. If the acceptances, including the participations the originator and other members of the bankers' syndicate desire to take, do not aggregate the entire issue, then the members of the bankers' syndicate will have to increase their participations in the distributing syndicate in order to complete its organization. We will assume the distributing syndicate completed before the closing day, and that the manager has arranged the carrying loan on behalf of the distributing syndicate. At the closing, deliveries of the issue from corporation to originator, from originator to bankers' syndicate, from bankers' syndicate to distributing syndicate, and from it to the bank making the loan, are all constructive. The bonds are on hand, and to conclude the purchase transaction the bank takes bonds as collateral and pays the purchase price out of funds which the bank loans and the bankers contribute as their equity in the transaction.

WITHDRAWN PARTICIPATIONS

The provision in the syndicate agreement that members may withdraw bonds has not yet been explained. Under the terms of the agreement a participant may substantially fulfil his obligations to his fellow members by taking up and paying for bonds on the terms stated. These bonds the member agrees not to sell during the life of the syndicate. Article V, Section 3, of the Rules of the Code of Fair Practice provides that: "No investment banker proposing to organize a selling syndicate or a selling group shall invite or permit any person to be a participant in such selling syndicate or a member in such selling group unless such person is an investment banker actually engaged in the investment banking business." Whether this rule will continue to be ob-

served or not remains to be seen. Time was when probably the purpose of such a withdrawal was to permit institutional and other large investors to buy bonds wholesale at a price which does not include a bankers' profit. For the distribution to smaller investors it is an advantage to have such large blocks disposed of and out of the retail market. Such disposition, though not strictly, is essentially intended to be a price concession for such buyers.

Probably, under the form of the clause as it appears in the syndicate letter in the previous chapter, the investor is not absolutely out of the risk of possible defaulting participants. The clause could be so worded, to be sure, as to make an agreement that the other members would assume this risk. And there is still the question of liability on the bank loan, which of course could not become absolute if no member defaulted.

We will not concern ourselves, however, with the problem of such possible liabilities, but merely note that if a participant makes use of this provision the situation is spoken of as a "withdrawn participation." There is not much likelihood that the contingent liabilities of any will fall in, or, if they do, that the manager will not take care of them for the sake of good will. An investment banker, believing that the price of the bonds will rise in the market after their distribution and the closing of the syndicate, might assume a speculative position by taking advantage of the clause.

REGULATION OF SELLING

Provisions of the syndicate agreement for the regulation of selling aim: (1) to control representations so that liability for misrepresentation may not arise; (2) to prevent a participant from gaining an advantage by beginning to sell before other participants; (3) to guard against an undesired oversale of the issue; (4) to control the secondary market while making the primary market; (5) to arrange delivery and payment so as to reduce risk and avoid confusion.

ADVERTISING

It is customary for the manager to prepare an advertisement for appearance in the newspapers on the day set for public offering. It runs in size to a quarter of a newspaper page. The manager

must arrange to have the advertisement appear simultaneously in all cities where advertising is to be done. To accomplish this it may even become necessary to telegraph the text to distant points. But with the facilities of air mail available, probably the manager will not be obliged to resort to telegrams. Bankers are now governing their advertising practice by the provisions of the Securities Act of 1933.

CIRCULAR OR PROSPECTUS

Federal regulation of the sale of securities presents many problems, and among the most difficult the development of a well defined practice for printed matter. The Securities Act of 1933 (Section 5, b, 2) requires the seller to furnish the investor with a copy of a prospectus making the essential disclosures required in the registration statement (Section 10). But the act does not, in its express terms following, prohibit the use of printed matter in shorter form than the prospectus: "It shall be unlawful for any person directly or indirectly *** to carry or cause to be carried through the mails or in interstate commerce any such security for the purpose of sale or for delivery after sale, unless accompanied or preceded by a prospectus that meets the requirements of Section 10." Rather interestingly Section 10 says: "In any case where a prospectus consists of a radio broadcast, copies thereof shall be filed with the Commission under such rules and regulations as it shall prescribe." Is a radio broadcast a prospectus preceding the transmission of the security so as to satisfy the requirements of Section 5, b, 2? In practice the prospectus complying with the Federal Act is used now in the place of the former circular.

BEATING THE GUN

"Beating the gun," as a phrase used in connection with syndicate transactions, contains a picturesque metaphor aptly applied. At a track meet the runners, ready to start the race, toe the mark. The official starter gives the signal to be off by firing a revolver. A nervous or unscrupulous runner may start before the shot. So, in a distributing syndicate, all the participants line up under the agreement ready to start selling as soon as the signal is given by the arrival of the public offering day. Beginning to canvass before that day beats the gun. On the race track the starter can

call back the premature runner. A syndicate participant who beats the gun keeps on in the race. If everything necessary for beginning to sell the issue had been done before the preparation of the syndicate agreement, it might have given the specific date for the public offering day. But at the time of printing the agreement, probably the advertising had not been prepared. Many other matters may need attention before selling can begin.

In order that every participant may have a fair chance for preparation, the rules of the Code of Fair Practice (Article V, Section 2) require that:

> Any investment banker proposing to organize a selling syndicate or a selling group to distribute new securities other than those of the United States Government or any instrumentality thereof or of any State or subdivision or instrumentality thereof shall mail or deliver or telegraph a copy of the prospectus or an adequate description of the security to each investment banker who is to be offered a participation in such syndicate or a membership in such selling group, at such times that, in the usual course of delivery, such prospectus or description will be received by all such investment bankers on approximately the same day and at least three days (excluding Sundays and holidays, but including the day of delivery) before the date on which it shall be proposed to make the public offering of such securities.

We repeat that, though the Code has no legal sanctions, its provisions are quoted to indicate opinions on good practice.

OVERSALES

The syndicate agreement requires participants to make sales subject to confirmation from the manager. If participants could sell "firm" the result might be that the issue would be heavily oversold, and the syndicate in a short position which might involve a heavy loss in covering. Under the operation of the syndicate provision the manager controls every sale, knows just where the syndicate stands, and can notify participants promptly when the issue is sold out.

It is common practice, however, for the syndicate to oversell to some extent when it can. Bankers want to establish a good secondary market. It creates good will. If the market price after the close of the syndicate advances above the syndicate selling price, investors who bought bonds of the issue are happy. In the mood induced by this experience, they more readily make

further commitments. It lays a foundation for bringing out further issues. Conversely, a drop in the market price after the close of the issue makes investors dissatisfied with the dealers who sold the bonds which show a loss, and disinclined to make commitments in further issues. If an investor has funds, he is then more likely to turn to securities already in the market.

So it is important for the bankers to have the secondary market make a good showing. If on the public offering they sell more than the entire issue, they are in a position to buy bonds offered in the market. The short position of the syndicate acts as a buffer. As long as it lasts, a firm bid in the market absorbs offerings and sustains price.

SHARPSHOOTERS

One factor in the market especially makes the close of the syndicate a critical period. Sometimes speculators in new issues become numerous. Men who believe an issue likely to meet public favor to such an extent that investor demand will not only absorb it on the public offering, but in the secondary market will bid the security up above the syndicate price, buy bonds, not as investors intending to hold them primarily for income, but as speculators hoping to make a quick profit. They sell their bonds very soon after buying them, and make their profit or take their loss as the case may be.

Investor demand after the syndicate had sold out might prove strong enough to absorb this speculative selling. The syndicate manager to whom participants report all sales has his finger on the pulse of the market. If the demand is strong, and likely to result in bidding up the price, he will not confirm any sales in excess of the amount of the issue. To take a short position would be likely to cause loss in covering. If the buying, however, is not eager, but good enough for ready selling, he will let the participants go ahead and will confirm their sales in excess of the aggregate of the issue until he believes the short position large enough to support the post-syndicate secondary market. The name "sharpshooter" is sometimes applied to the man who speculates on the syndicate transaction. When an issue is oversubscribed on announcement of its offering, his operations are likely to account for some of the oversubscriptions.

CONTROL OF THE SECONDARY MARKET WHILE MAKING THE PRIMARY MARKET

Speculators do not necessarily wait until an issue is entirely distributed before selling. They have their opinions of the market, and may decide to get out at any time. Of course it would be fatal to the success of the syndicate operation to have bonds of its issue sold in the open market at less than the syndicate price. The syndicate must support the market at least through the period of distribution.

To aid in this support the syndicate agreement provides that: "The manager shall have the right to purchase for the syndicate account any bonds of this issue which may be offered in the market during the term of the syndicate at or below the public offering price, and may require a participant to repurchase at cost to the syndicate such bonds sold by or through the participant; or the manager may, in its discretion, withhold from the participant the selling commission due on such bonds." This express authority to the manager makes each participant responsible for the quality of his selling.

When a member of a syndicate sells bonds, the investor is free to deal with them. He may resell immediately. The participant cannot know certainly that his buyer will not resell, and may believe the bonds bought with a firm intention to hold. If the participant in a syndicate, however, is not made responsible for the investment character of his sales, he might stimulate selling by pointing out, or even urging, the speculative opportunity, and definitely endeavor to sell to speculative buyers. The syndicate manager cannot know what the participant believes about his buyer. So the agreement makes the member absolutely responsible.

On sending out bonds for delivery the syndicate manager keeps a record of their serial numbers. He would do this anyway, as would any dealer through whose hands securities pass, to assist in possible tracing and recovery in the event of loss or theft in transmission, or, for that matter, after the bonds are in the hands of the buyer. But the manager's record also serves the useful purpose of supplying the manager with the name of the member who sold bonds which come on the general market before the syndicate has completed its distribution of the issue.

In a stock syndicate, this tracing would require access to the transfer agent's records, because the purchaser might transfer

his stock, and the new certificate would furnish no evidence enabling the manager to identify the participant who sold the shares for the syndicate. The originator's commitment with the corporation to form an underwriting syndicate might well stipulate for access to the corporate record of stockholders during the term of the syndicate, and for a period thereafter.

The syndicate agreement gives the manager the option of requiring the participant to take up such repurchased bonds, or of canceling the allowance of a commission on them. Presumably it is the intent of the syndicate agreement that the original sale of these bonds by the participant should not count in the fulfillment of his liability to the syndicate. An additional clause might well expressly state this to leave no doubt of the intent.

It will be noted that the authority of the manager, either to require repurchased bonds to be taken up or to cancel commissions, extends only to bonds repurchased at or below the syndicate selling price. If, in the general trading account provided for by another clause of the agreement, the manager should buy bonds at a price above the syndicate price, the participant has no responsibility for their having come into the market. Also it will be noted that the price to be paid by the participant on taking up repurchased bonds is their cost to the syndicate, which does not endeavor to make a profit out of selling which may have been only unfortunate and not wilfully unsound.

TRADING ACCOUNT

A corporation may have outstanding, say, \$20,000,000 of bonds of an authorized issue of \$50,000,000 and sell to its bankers \$10,000,000 of the authorized and unissued bonds. Such a situation complicates the marketing problem. The bankers buy the additional bonds at a price related to the market quotation on those outstanding. But the market may not of itself conveniently stay firm to enable the bankers to carry through their syndicate transaction. With bonds of an issue no part of which was already outstanding, the secondary market does not begin until the bankers have started their primary market.

Though that very fact creates a problem of nursing a secondary market into an orderly self-existence, the bankers have nothing to do on it before they begin selling on their own account. The provision in the syndicate agreement authorizing the manager to

buy bonds offered in the market at or below the selling price might be adequate to enable him to handle the secondary market. If bonds of the same issue are already outstanding, it may be more important that he should have the wider scope of a general trading account.

COOKING THE MARKET

Doubtless a temptation to "cook the market" often presents itself to corporation managers and to bankers. The corporation about to offer for sale additional bonds of an issue, bonds of which are already outstanding, may by its own buying artificially stimulate the market price in an endeavor to obtain better terms from the bankers. Or when the bankers have committed themselves to the purchase from the corporation, they may stimulate the market to lay a foundation for a higher asking price, and to whet the appetite of investors seeing the market advance.

Such misleading manipulation is socially undesirable. Under our security marketing methods, a market control during distribution is necessary. Just how and when to draw the line between improper manipulation and necessary control may be extremely difficult. Rules of the Code of Fair Practice (Article V, Section 15) provide that:

> Except as to public securities sold by the issuer thereof at public sale, if either (1) the manager of any selling syndicate or the manager of a selling group, or (2) to the knowledge of any such manager, the issuer or originator or any other syndicate formed in connection with the distribution of any new issue of securities to be distributed by or through such selling syndicate or selling group, purchases any of the outstanding securities of the issuer in the open market within ten days prior to the date on which such securities are first offered to the public, such fact shall be disclosed by the manager to all participants in the selling syndicate or members of the selling group, and shall also be disclosed, either in the prospectus or in some other manner, by each participant in the selling syndicate or member of the selling group to any person purchasing the securities from such participant or member; provided, however, that no disclosure shall be required under this Section 15 of any purchases of outstanding securities of the issuer made for the purposes of the sinking fund.

Since this rule covers purchases of any issue of the issuer, if the securities to be distributed were bonds, and stock were bought nevertheless, the purchase of the stock should be disclosed. Ma-

nipulation of the price of the stock might have a sympathetic effect on the price of the bonds of the corporation.

Under the terms of our hypothetical syndicate the manager may have a trading account only up to fifteen per cent of the amount of the issue. The trading account is a dangerous part of the syndicate operation, and this limitation of its size is intended to reduce the possible loss. The size allowed is intended to be sufficient to enable the manager to stabilize the market.

DELIVERIES

Our illustrative syndicate agreement provides that "all sales shall be made 'when, as, and if issued and received and subject to confirmation,'" and that "members shall not sell against their participations unless, and to the extent that, participations are taken firm." Elsewhere it states that "on notice to the manager at the time of acceptance of a participation, a participant may have bonds firm for immediate sale to any amount equal to the full amount of the participation, and may subscribe, subject to allotment in the absolute discretion of the manager, for an amount in excess of the full amount of the participation."

Provision that all sales shall be made "when, as, and if" is for contractual precaution. It may be that the syndicate is organized and begins selling before the closing day. Even though the bankers may have already verified the corporate representations, it may yet happen that legal difficulties, interfering with the creation of a valid obligation with the mortgage security stipulated, will prevent delivery of the issue to the bankers. It is not impossible, though improbable, that the corporation may refuse to perform on the contract to sell. It may feel that it has been defrauded into undertaking it, and that it would have a defense against an action for breach. Until actual delivery of the bonds to the bankers, reasonable caution requires that they do not make any unconditional contracts of sale.

"Subject to confirmation" appears, as already remarked, in order to give the manager such control that undesired overselling the issue cannot happen.

FIRM BONDS

But if a member wants to be free from the condition of confirmation he may, on accepting his participation, take bonds firm

up to the amount of the participation. If he takes bonds firm, he foregoes the possible advantage that oversales of the participations of other members may relieve him of part of his liability to the syndicate. He gains the advantage of knowing that he can have for sale at least the amount of bonds he has taken firm.

The syndicate agreement can provide that participants may as a matter of right take bonds firm up to the amount of their participations. The utmost that can happen is that every participant will take firm bonds up to the full amount of his participation, an event which for the purpose of firm bonds would exhaust the issue. But the agreement cannot promise a participant all the bonds he may want to have reserved for his selling. That might result in demands for reservations in excess of the amount of the issue.

SUBSCRIBED BONDS

However, it may be possible to meet the desires of participants for reserved bonds in whole or in part. So the agreement goes on to provide that "members may subscribe, subject to allotment in the absolute discretion of the manager, for an amount in excess of the full amount of the participation." Such a subscription means that the member undertakes to oversell his participation by the amount subscribed.

Market conditions, the nature of the issue, and its price may lead to a belief that the security will be in great demand. A dealer desires to satisfy the wishes of his customers, and get the benefit of any selling commissions allowed. Under these circumstances he wants to have the command of bonds. If he could have named the amount of his participation, he might well have made it larger. But the originator organizing the syndicate offered a participation of only the indicated amount. With an issue promising popularity he wants to offer all who are usually in his syndicates an opportunity to participate. To those who may want more bonds than the amount of the participations offered, the organizer can give a privilege of subscription subject to allotment.

The manager reserves the right to make allotments in his absolute discretion. He may not want to allot pro rata to subscriptions. If the issue seems likely to be in great investor demand, participants may subscribe much in excess of the amount of bonds they really need, expecting their subscriptions to be cut

down on allotment, and hoping to get a larger allotment than they would on a smaller subscription. We have the spectacle of shoving at the trough often observable in human affairs. By allotting in discretion, instead of necessarily pro rata, the manager can prevent one participant from gaining an advantage over the others. The manager can also prevent the assumption of greater liability than he believes a participant can safely carry.

Further to assure the good faith of such subscriptions the rules of the Code (Article V, Section 7) state that:

(b) Except as hereinafter provided in paragraph (c) of this section, whenever new securities are subscribed for subject to allotment from the manager by a participant in a selling syndicate or a member of a selling group he shall at the time of such subscription make a down payment of not less than 5% of the public offering price. Such down payments shall be deposited by the manager in a special account with one or more incorporated banks, trust companies or persons permitted to receive deposits, provided, however, that they shall in all cases be deposited with a bank, trust company or person other than the manager.

(c) No down payment as required by paragraph (a) of this section shall be required from any purchaser who may be prevented by law from making such payment in advance of the delivery of the security purchased; and the participant or member who accepted the subscription of such purchaser shall furnish the manager of the selling syndicate or selling group evidence of such fact satisfactory to the manager, and in such case such participant or member shall not be required to make the down payment as required by paragraph (b) of this section; and the fact that such down payment is not required in any such case shall not be considered as a concession under Section 4 of this Article. The requirements of paragraph (b) shall not be compulsory in the case of a selling syndicate where all the participants were parties to the purchase from the issuer of the new security to be distributed.

Paragraph (a) relates to sales by members of the syndicate to investors, and we are not concerned with it at this point. We are not at this point interested in paragraph (b). A requirement that a member must put up an amount of cash on subscribing tends to prevent participants from padding their subscriptions. Probably the exception in paragraph (c), that no down payment shall be required from a participant on subscription, provided a purchaser is prevented by law from making a down payment, appears for the purpose of covering participants who make their subscriptions on the basis of applications already received from

customers. The fact that an issue is about to be offered to investors may be well known financial news before the formation of the selling syndicate. Ethics of syndicating seem not to prevent a dealer from soliciting applications before he has become a member of the syndicate. Indeed, this paragraph of the rules seems expressly framed to permit such solicitation.

Most purchasers, however, would not be prevented by law from making a down payment and, therefore, the dealer would either have to supply the five per cent from his own funds or get it from his customer applicant. Probably the reference to being prevented by law covers the possibility that, for example, insurance companies in some States might not be permitted to pay out funds for investments without at the same time receiving the paper evidencing the actual security.

DELIVERY AND PAYMENT

Managers retain absolute control of deliveries from and payments to the syndicate account. They are the responsible agents for the preservation of the syndicate assets and the proper distribution of profits. So they make no delivery of securities until they have received the proper amount of funds. Another cogent reason requires that they receive payment before making delivery. The bank which has made the carrying loan holds the bonds as collateral and will not deliver any of them to the manager until a pro rata of the loan is repaid. If a participant did not transmit the funds necessary to repay the proportionate part of the loan, the manager would have to finance the clearance out of his own funds.

Let us review the course of the transaction. A participant's salesman closes a sale, "subject to confirmation," and notifies his house. The participant immediately notifies the manager, usually by telegraph or telephone, and transmits funds. On receipt of these funds the manager pays off that amount on the loan, the bank delivers the number of bonds called for to the manager, who transmits them to the participant dealer who sold them. The dealer delivers them to the customer and receives payment.

It is apparent that the dealer participating in a syndicate must have enough capital to enable him to effect clearance transactions of ordinary size. No doubt if the sale were large, say $25,000 or more, a special arrangement could be made. If the

customer were willing, he could take delivery at his bank, and the bank making the syndicate loan could ship the bonds to the customer's bank with draft attached. But a request to a customer to handle a transaction in this way might annoy him, and it would amount to an admission of the dealer's inability to clear.

SPECIAL COMPENSATION OF PARTICIPANTS FOR SERVICES

One needs constantly to keep in mind the distinction between risk and labor in a distributing syndicate. A house might have a participation of $100,000 in an issue, but, due to the fact that other houses sold more than the amounts of their participations, might not have to sell or take up any of the bonds. Such a house, sharing pro rata in the profits, would benefit as much as if it had performed its share of the work. Usually the organizer of a selling syndicate endeavors to provide compensation to those who do the work, as distinguished from those who carry their part of the risk without performing the proportionate part of the labor.

Selling commissions accomplish the desired result. They might be allowed at the same rate on all sales and charged as an expense of the syndicate. If every participant sold the exact amount of his participation, each in the net result would get just what he would have received if no commissions had been allowed.

Assume (situation 1), however, that though the syndicate sells all the bonds, some participants selling more than their pro rata make up the deficiency of those who sell less. The overselling member, to be sure, receives some compensation for his extra labor, but not as much as he seems to be getting. Since the commissions are charged to the syndicate account as an expense, a participant to the extent of $100,000 in a syndicate of a $1,000,000 issue would be paying one-tenth of his own commissions, and a tenth of the commissions of anyone else who sold more than his pro rata. A participant to the extent of $100,000 who has not sold his share pays only one-tenth of the commissions of those who sell more than their participation amounts.

Further, assume (situation 2) that a syndicate for an issue of $1,000,000 has sold only $500,000 and has $500,000 to distribute to its members, and that participant A with a participation of

$100,000 has sold $75,000, and B with a participation of $100,000 has sold $25,000. On allowance of a commission of one per cent A will receive $750 and B $250. Since both commissions are charged to the syndicate, A, in effect, will pay one-tenth of his own commissions and one-tenth of B's commissions.

COMMISSIONS ON OVERSALES

Instead of allowing commissions on all sales, a syndicate agreement might provide for commissions only on sales in excess of the amounts of participations. Then, if such commissions were chargeable as a syndicate expense, situation 1 would work out in the same way, but in situation 2 neither A nor B would be credited with any commissions.

OVERSALES COMMISSIONS CHARGED AGAINST UNDERSALES

The form of syndicate agreement presented in the previous chapter provides for a commission on all sales chargeable as a syndicate expense and for an additional commission on oversales chargeable against those participants who have undersold. Charging commissions on oversales against underselling participants gives a strong incentive to each participant to perform his pro rata of the work. Here the participant who does not do his own share of the work in effect directly pays someone else to do it for him; and the one who does more than his share receives a payment to which he does not contribute.

Just what share of the total syndicate compensation ought to be allocated to work and what to risk may be debatable. Certainly the share would vary both with the type of security and the condition of the market; or saying the same thing in another way, the risk varies from time to time, and at any one time from issue to issue. An originator organizing a syndicate must judge as best he can what will appear to those to whom he offers participations to be a fair bargain.

INVESTORS' SUBSCRIPTIONS SUBJECT TO ALLOTMENT

Certain types of issues require much work in selling under any market conditions. Other issues, under favorable market conditions, may be so much in demand that investors take them up

readily. One of the several greater originating houses may insert in the advertisement of the issue that subscriptions will be received subject to allotment. The issue may be for $25,000,000 and subscriptions received aggregating $50,000,000 or more. Such a situation does not mean that there is no syndicate or that no selling work has been done.

Investors do not buy bonds that have not been called to their attention in some way. Many may have seen the advance publicity of the issue, and some would have subscribed entirely of their own initiative. But there is a selling syndicate, and for the most part the subscriptions come as a result of solicitation by dealers, either in anticipation of becoming participants, or after public offering date set ahead of the advertising day. Dealers will have the subscriptions in hand, and presented to the originating manager before the advertisement of the issue. On the morning of the advertisement the banking house of the manager may have subscriptions largely in excess of the issue. Under such circumstances he may "close" the subscription books immediately on "opening" them. Or, more likely, the house will leave them open for the day for belated subscriptions to come in, especially from a distance.

Allotment problems of the originating house on organization of the syndicate differ somewhat from those on public offering. As already pointed out, the manager allots on participants' subscription with a view to fairness among members, and their probable abilities to perform. In alloting on the public offering, besides fairness, the manager must keep in mind the secondary market. If the issue gives promise of an oversubscription the problem of the speculative buyer becomes especially pressing. Instead of allotting pro rata the manager ordinarily gives a preference to the smaller subscriptions as less likely to represent speculations. For example, on subscriptions for $5000 or less, the allotments might be for the entire amount, above $5000 and up to $10,000 they might be for $5000 and fifty per cent of the amount in excess, and so on.

Subscriptions are said to be "padded" when, in anticipation of an oversubscription and consequent cutting down in allotment, they are made for amounts in excess of those the subscriber really wants. Rules of the Code of Fair Practice requiring a down payment should tend to reduce such padding. The rule appears in paragraph (a) of Article V, Section 7, of which paragraphs (b),

relating to syndicate subscriptions, and (c) have been quoted. Paragraph (a) is:

Except as hereinafter provided in paragraph (c) of this section, whenever a participant in a selling syndicate, or a member of a selling group, accepts a subscription subject to allotment for the purchase of a new security to be distributed by such selling syndicate or selling group, he shall require the person making the subscription to deposit with him a down payment of not less than five per cent of the public offering price on the securities subscribed for.

ISSUES OVERSUBSCRIBED BY INVESTORS

News statements that subscriptions received have been for more than twice the issue (or whatever the oversubscription may be) often give a mistaken idea to people entirely unfamiliar with the security business. They are likely to think that investors with funds in the aggregate amount of the subscriptions are eagerly seeking to commit them to the security offered, and to the extent that these investors are disappointed, they will have to buy other securities. Though there is no way of telling just to what extent an oversubscription represents padding, probably a large part of any great excess is of that character. Some investors, anticipating that subscriptions will be cut down on allotment, instead of padding, get other people to put in subscriptions in their own names for the smaller amounts that are not likely to be cut, or not cut as much as an application for a larger amount.

BRITISH SYNDICATE PRACTICE

In the London market, issues are regularly advertised for public subscription subject to allotment. Ordinarily one of the great British joint stock banks acts as an agent to receive subscriptions for the syndicate. If on the public offering the issue is not fully subscribed, participants in the syndicate are called on immediately to take up the unsold securities and the syndicate is closed. Since the syndicate as such has no selling to do, and in no event will any participant have to take up more than his pro rata, the situation does not call for the divided account syndicate which has developed in the United States and Canada. Also commissions for oversales are not provided. But participants and brokers are allowed a commission on allotments on subscriptions received through them.

Such a practice results in an immediate absolutely free secondary market in the issue. Our method of primary marketing, with the syndicate as such endeavoring to sell the issue, requires that the secondary market be pegged by the syndicate as we have seen, at the selling price. An investor familiar with our marketing process may recognize the pegging and infer that the syndicate is still distributing.

A public quotation which hardly varies at all from the offering price pretty clearly indicates that much of the situation. Even the experienced investor, however, cannot tell to what extent the marketing disappointed the bankers, or whether on the close of the syndicate the price will drop far. Though he may have bought the bonds with every intention to hold, the way the market acts may cause him to sell. His offering joins those of the sharpshooters to harass the syndicate manager.

It remains to be seen whether the Securities and Exchange Commission created by the Securities Exchange Act of 1934 will in any way endeavor to utilize the provisions of the act against any "manipulative or deceptive device" to interfere with syndicate pegging. Section 10 states that:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange — *** (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

One assumes that the Commissioners will not attempt to force entirely new practice in primary marketing. Forbidding a pegged price would force our securities business to use the British method of public offering and prompt termination of the syndicate.

Conditions in the United States do differ from those in England, and it may be that the differences are great enough to make immediate termination of the syndicate impracticable here. If we continue to use salesmen, probably such syndicate closure would increase the annoyances of their activity. Each participant taking over unsold bonds would tend to be pressing to get out of his risk. Though our territory is much greater than the British, modern facilities for communication seem to make this

not an insuperable difficulty. British stock exchange practice tends to the listing of small issues and making a fair secondary market in them, with not so great a spread as with us. Unless we develop better secondary markets for small issues, handling the primary market for them in the British way would probably be difficult.

Better secondary markets for small issues is something to be hoped for in the United States. The organization of the London stock exchange, with its jobbers making the market, standing ready to buy or sell on their own account, opens the way for dealings in relatively small issues. With us there might be an increase in the number of local exchanges. Or competition among non-member brokers and dealers might lead to closer over the counter markets.

CHAPTER XXXIV

Liquidating the Syndicate

One syndicate item needs further consideration before taking up the matter of liquidation in syndicate transactions. As we have seen, the manager arranges a bank loan to carry the bonds. Interest on this loan is, of course, a syndicate expense. But, as an offset, interest accrues on the bonds and is collected as they are sold. The selling price is always "and interest," and the accrued interest is computed to the date of payment for the bonds, and collected on delivery.

PROFIT OR LOSS ON INTEREST ACCOUNT

So a syndicate regularly has an item of profit or loss on interest account. It may be either profit or loss. If the bonds carry interest at six per cent and the bank charges five per cent on its loan, the interest account makes a profit; conversely, if the coupon rate is five per cent and the bank rate is six per cent, the account shows a loss. As the bonds are sold, the loan is liquidated pro rata and interest stops running to that extent. The amount of profit or loss depends on the time taken to sell the bonds.

If the syndicate were for an issue of $1,000,000, and $650,000 were sold in the first week and $35,000 a week for ten weeks thereafter, and the carrying loan were $900,000, then the $585,000 of the loan would be repaid in the first week and $31,500 each week thereafter; or, we would have, say, an average loan of $239,318.18 at five per cent for the carrying period of the syndicate. Correspondingly the bonds would accrue interest on an average balance of $265,909.09. Since the syndicate bought the bonds at 90, there is a differential, not only in the respective rates of interest, but also in that the bonds bear interest in their face amount and the bank loan is for only ninety per cent of the face of the bonds. These figures are presented for simplicity. In practice a bank would not loan nearly as much.

ILLUSTRATIVE SYNDICATES

This chapter will not be in any way a presentation of formal syndicate accounting, but will take up several very simple examples to illustrate the process of liquidation, and to summarize various matters presented in the preceding two chapters. The illustrations are not to be taken as presenting any syndicate, or any syndicate items as typical. Figures have been chosen entirely for the sake of simplicity. Also we will neglect any intermediate syndicate and any originator's profit. If the liquidation of selling syndicates is understood, these matters present no difficulties.

We will assume for all our illustrative syndicates the following facts:

Issue	\$1,000,000 6% bonds
Price paid by syndicate	90
Syndicate selling price	95

In each syndicate there are only four participants, and their participations are as follows:

Participant	*Amount of Participation*
A	\$400,000
B	300,000
C	200,000
D	100,000

Also we will assume in each case that the syndicate expenses are \$6250, and that the interest account shows a profit of \$1250.

EXAMPLE I: UNDIVIDED ACCOUNT — NO COMMISSIONS — ALL BONDS SOLD

An undivided account syndicate in which no commissions are paid. Participants sell all the bonds, not the amounts of their participations, but as presented in the tabulation below.

Gross profit on \$1,000,000 bonds at five points (difference between purchase price of 90 and selling price of 95)		\$50,000
Profit on interest account		1,250
Syndicate expense	\$6,250	
Net profit	45,000	
	\$51,250	\$51,250

Distributions in liquidation would be as follows:

Name of Participant	*Amount of Participation*	*Amount of Sales*	*Cash Distribution*
A	$400,000	$300,000	$18,000
B	300,000	400,000	13,500
C	200,000	100,000	9,000
D	100,000	200,000	4,500
	$1,000,000	$1,000,000	$45,000

That is, the participants are in fractions of a tenth. The distributions have nothing to do with relative amounts of the sales of the members, but only with their pro rata interests in the syndicate. One-tenth of the net profits amounts to $4500; and A, B, C, and D have respectively interests of 4, 3, 2, and 1 tenth.

EXAMPLE II: UNDIVIDED ACCOUNT — COMMISSIONS — ALL BONDS SOLD

An undivided account syndicate, in which a commission of one per cent on the face amount (one point) is paid on all sales as a syndicate expense. Participants sell all the bonds, not in the amounts of their participations, but as presented in the tabulation below. As before, the net profit is $45,000. But the allowance of commissions on sales changes the total of the distribution to each participant.

Name of Participant	*Amount of Participation*	*Amount of Sales*	*Commissions*	*Share of Profits*	*Total Compensation*
A	$400,000	$300,000	$3,000	$14,000	$17,000
B	300,000	400,000	4,000	10,500	14,500
C	200,000	100,000	1,000	7,000	8,000
D	100,000	200,000	2,000	3,500	5,500
	$1,000,000	$1,000,000	$10,000	$35,000	$45,000

EXAMPLE III: UNDIVIDED ACCOUNT — NO COMMISSIONS — UNSOLD BONDS

An undivided account syndicate to be liquidated with $250,000 face amount of bonds unsold. No commissions paid.

Gross profit on $750,000 bonds sold at five points (difference between purchase price of 90 and selling price of 95)		$37,500
Profit on interest account		1,250
Syndicate expenses	$6,250	
Net cash profit	32,500	
	$38,750	$38,750

Name of Participant	*Amount of Participation*	*Amount of Sales*	*Bonds to Be Taken Up*
A	$400,000	$300,000	$100,000
B	300,000	200,000	75,000
C	200,000	150,000	50,000
D	100,000	100,000	25,000
	$1,000,000	$750,000	$250,000

Since this is an undivided account, or limited liability syndicate, the right of participants is to share profits pro rata to their participations, and the obligation of participants is to bear losses in the proportion of their participations. On closed transactions the syndicate has made a profit, but it has not completed payment for the bonds (or, what is the same thing, it has not paid in full the loan with which the bonds were bought). It had an original liability for $900,000. Sale of bonds has reduced this liability by the amount of the proceeds on such sales, which include the profit on closed transactions.

Cost of $750,000 bonds sold	$675,000
Net profit on bonds sold	32,500
	$707,500
Original amount of carrying loan	$900,000
Paid on carrying loan, or available to pay	$707,500
Balance for carrying loan	192,500
	$900,000

This balance payable on the carrying loan amounts to 77 on the $250,000 bonds still held. Participants ought to be called upon as follows:

Name of Participant	*Bonds to Be Taken Up*	*Cash to Be Paid*
A	$100,000	$77,000
B	75,000	57,750
C	50,000	38,500
D	25,000	19,250
	$250,000	$192,500

This is the same result that would be arrived at if we treated the situation as one involving a balance in cash and a balance in securities to be taken up at the syndicate purchase price of 90. In that case we would have:

Name of Participant	*Share of Cash Profit*	*Bonds to Be Taken Up*	*Cost at 90*	*Cost Less Cash Profit*
A	$13,000	$100,000	$90,000	$77,000
B	9,750	75,000	67,500	57,750
C	6,500	50,000	45,000	38,500
D	3,250	25,000	22,500	19,250
	$32,500	$250,000	$225,000	$192,500

EXAMPLE IV: DIVIDED ACCOUNT — NO COMMISSIONS ON SALES — UNSOLD BONDS

A divided account syndicate to be liquidated with $250,000 face amount of bonds unsold. The profit on sales is the same as in Example III, $32,500. Sales of each participant are assumed as given below.

Name of Participant	*Amount of Participation*	*Amount of Sales*	*Share of Cash Profits*
A	$400,000	$200,000	$13,000
B	300,000	100,000	9,750
C	200,000	350,000	6,500
D	100,000	100,000	3,250
	$1,000,000	$750,000	$32,500

Name of Participant	*Undersales*	*Oversales*
A	$200,000	
B	200,000	
C		150,000
D		
	$400,000	$150,000

If it were not for the fact that C has oversold his participation in the amount of $150,000, A and B would each have an obligation to the syndicate to take up $200,000 of bonds. The amount of bonds actually to be taken up is not $400,000, but $250,000. The participation of A is four-sevenths and of B three-sevenths of their aggregate participations. Oversales of C are an advantage to the syndicate, but the conditions of the syndicate are such that this advantage accrues solely to A and B. Participants, on general principle, share an advantage in proportion to their participations, and the ratios of the participations of A and B are four to three. So the obligation of A to take up to the amount

of his participation has been reduced by four-sevenths, and of B by three-sevenths, of \$150,000. We have this situation:

Undersales of A	\$200,000
Credit to A for share of oversales of C	\$85,714.28$\frac{4}{7}$
Balance for A to take up	114,285.71$\frac{3}{7}$
	\$200,000.00
Undersales of B	\$200,000
Credit to B for share of oversales of C	\$64,285.71$\frac{3}{7}$
Balance for B to take up	135,714.28$\frac{4}{7}$
	\$200,000.00
So A should take up	\$114,285.71$\frac{3}{7}$
And B should take up	135,714.28$\frac{4}{7}$
Total to take up	\$250,000.00

Since the exact amounts cannot be delivered, presumably A would be called on to take up \$114,000 and B \$136,000 of the unsold bonds.

This is the solution of the problem of the ratio for crediting oversales against undersales given by Galston in his work on Security Syndicate Operations (Revised Edition, pp. 175, 176) and seems to be in accordance with partnership principles, which apply unless the partnership agreement expressly stipulated to the contrary.

However, it would seem fairer to require the undersold participants to take up unsold bonds in proportion to their undersales and not in proportion to their participations. If A and B had performed their shares of the labor, there would be no unsold bonds to take up. On that basis, since their undersales are equal, each would take up \$125,000 of bonds.

It would seem desirable to have the syndicate agreement expressly state the proportion in which undersold participants would benefit by oversales. Even though the proportion only stated the rights of the parties in the absence of express provision to the contrary, still the expression would make for avoidance of misunderstanding.

We still have a most important problem in connection with divided accounts. At what price should undersold participants take up unsold bonds? An earlier page stated that the obligation of the members was to take up unsold bonds at the price the syndicate paid for them. It would have made no final difference

if they paid the syndicate selling price. They take up bonds in proportion to their participations and share profits in the same proportion, so that the additional amounts they would be charged for the bonds would be just so many additional credits on the payment for them. But there is no point in requiring cash to be paid in by the participants, only to be at once returned to them in the same amounts.

In a divided account, however, members do not take up bonds in proportion to participations; but if they pay more than the syndicate purchase price, the additional amount would be allocatable to all members in the proportion of their syndicate shares. Before going further into the matter, however, let us present the liquidation statements of our syndicate in this Example IV on the assumption that bonds are to be taken up at the price of 90 paid by the syndicate.

Name of Participant	*Share of Profit*	*Bonds to Be Taken Up*	*Cost at* 90	*Cash Payment after Credit of Profit*
A	$13,000	$114,000	$102,600	$89,600
B	9,750	136,000	122,400	112,650
C	6,500			
D	3,250			
	$32,500	$250,000	$225,000	$202,250

If the undersold participants were called on to take up the unsold bonds at 95, the result would be as follows:

Name of Participant	*Share of Profit*	*Bonds to Be Taken Up*	*Cost at* 95	*Cash Payment after Credit of Profit*
A	$18,000	$114,000	$108,300	$90,300
B	13,500	136,000	129,200	115,700
C	9,000			
D	4,500			
	$45,000	$250,000	$237,500	$206,000

Profits of C and D would increase from an aggregate of $9750 to an aggregate of $13,500 or an aggregate increase of $3750, which is just the increase in the amount paid by A and B on taking up the unsold bonds.

Let us test the matter out in a syndicate in which there are unsold bonds but no oversales. The situation would then be as follows:

EXAMPLE V: DIVIDED ACCOUNT — NO COMMISSIONS — NO OVERSALES — UNSOLD BONDS

Name of Participant	*Amount of Participation*	*Amount of Sales*	*Undersales*
A	$400,000	$300,000	$100,000
B	300,000	200,000	100,000
C	200,000	200,000	
D	100,000	100,000	
	$1,000,000	$800,000	$200,000

On the sale of $800,000 of bonds at a gross profit of five points the gross profit would be $40,000, which, with profit on interest account of $1250, less expenses of $6250, would result in a net profit of $35,000, before any allowance on account of unsold bonds. With the unsold bonds taken up at 90, and so not changing the net profit, the result would be:

	Name of Partici-pant	*Share of Profit*	*Bonds to Be Taken Up*	*Cost*	*Cash Payment after Credit of Profit*
Unsold bonds taken up at 90	A	$14,000	$100,000	$90,000	$76,000
	B	10,500	100,000	90,000	79,500
	C	7,000			
	D	3,500			
		$35,000	$200,000	$180,000	$155,500
Unsold bonds taken up at 95	A	$18,000	$100,000	$95,000	$77,000
	B	13,500	100,000	95,000	81,500
	C	9,000			
	D	4,500			
		$45,000	$200,000	$190,000	$158,500

On taking up the unsold bonds at 95 the following aggregate payments to the syndicate would have been made by the members:

A

Sold $300,000 at 95		$285,000
Charged for $100,000 at 95	$95,000	
Credit for share of profit	$18,000	
Cash	77,000	
	$95,000	
Paid cash on taking up $100,000 unsold bonds		77,000
		$362,000

B

Sold $200,000 at 95		$190,000
Charged for $100,000 at 95	$95,000	
Credit for share of profit	$13,500	
Cash	81,500	
	$95,000	
Paid cash on taking up $100,000 unsold bonds		81,500
		$271,500

C

Sold $200,000 at 95	$190,000
Share of profit	$9,000
Net contribution to syndicate	181,000
	$190,000

D

Sold $100,000 at 95	$95,000
Share of profit	$4,500
Net contribution to syndicate	90,500
	$95,000

Stating the matter another way, and considering the expense of the syndicate less the profit on interest account as a net expense, to be borne pro rata as a syndicate liability, in addition to the cost of the bonds, we get the same net results as follows:

Name of Participant	*Partici-pation*	*Cost at 90*	*Share of Syndicate Expense*	*Total Lia-bility to Syndicate*
A	$400,000	$360,000	$2,000	$362,000
B	300,000	270,000	1,500	271,500
C	200,000	180,000	1,000	181,000
D	100,000	90,000	500	90,500
	$1,000,000	$900,000	$5,000	$905,000

Compare this result with the result of taking up the unsold bonds at 90.

Name of Participant	*Contribution to Syndicate Unsold Bonds Taken Up at 95*	*Contribution to Syndicate Unsold Bonds Taken Up at 90*	*Greater by*	*Less by*
A	$362,000	$361,000		$1,000
B	271,500	269,500		2,000
C	181,000	183,000	$2,000	
D	90,500	91,500	1,000	
	$905,000	$905,000	$3,000	$3,000

So if the syndicate were liquidated by calling on A and B to take up the unsold bonds at 90, the result would be that C and D would bear more than their share of the total syndicate liability of purchase price plus expense. The phrase in the illustrative syndicate agreement relating to the matter is: "The maximum liability of a participant will be for the amount of bonds stated on the participation at the net cost to the syndicate, including cost of advertising, printing, mailing, telegrams, cables, legal and other expenses properly chargeable to the syndicate, and any participant who effects sales equal to the entire amount of his participation will be under no further liability, except as hereinafter provided on account of bonds sold by the participant and repurchased for the syndicate account by the manager." That is, the net cost is the purchase price plus the pro rata of expense, and, in the divided account syndicate, having the unsold bonds taken up at the syndicate selling price works out the stipulated result.

EXAMPLE VI: DIVIDED ACCOUNT — SOME BONDS UNSOLD — SELLING COMMISSION — OVERSALES COMMISSION

To show the effect of commissions in dividing compensation we will take up a final example involving both a commission on all sales and a commission on oversales. We will take the commission rates provided in our illustrative form of agreement. Oversales commissions are charged against those who undersell.

Name of Participant	*Amount of Participation*	*Amount of Sales*	*Share in Cash Profits*
A	$400,000	$200,000	$15,000
B	300,000	100,000	11,250
C	200,000	350,000	7,500
D	100,000	100,000	3,750
	$1,000,000	$750,000	$37,500

Commissions on Sales	*Add Commissions on Oversales*	*Deduct Commissions on Oversales*	*Net Profits and Commissions*
$2,000		$375	$16,625
1,000		375	11,875
3,500	750		11,750
1,000			4,750
$7,500	$750	$750	$45,000

And, of course, as in Example IV, A would be called upon to take up $114,000 and B $136,000 of the bonds at 95.

ACCOUNTING TO PARTICIPANT

Rules of the Code of Fair Practice provide (Article V, Section 13):

> The manager of any syndicate shall distribute the amount due to syndicate participants promptly after the close of the syndicate. Upon request of any participant, the manager shall render to him a statement of expenses, which statement shall show the aggregate amounts of: (1) payments to manager, if any; (2) legal expenses; (3) advertising expenses; (4) expenses for printing, engraving, mailing, telegrams and cables; and (5) other expenses.

Presumably a participant as one of the partners in the joint venture has a right on demand to a complete accounting from his co-partner, the manager. Unless a member has a strong suspicion of inaccuracy in the distributions, he would probably not deem it expedient to call for a complete accounting. Such a demand might make him unpopular as a participant and result in his being left out when the invitations to other syndicates are made up. Although the members are partners, they do not know the amounts of participation of their fellows in a syndicate of such numbers as are usually involved in distributing an issue, and they might well regard as undesirable any general knowledge of the amounts of their participations. In addition to a statement of expenses they should receive a statement of total sales and of total oversales. With this additional information they would be in a position to compute for themselves the amounts they should receive and pay.

CHAPTER XXXV

Secondary Markets

Chapters on security syndicates have indicated that the term "primary market" refers to the original selling of securities, through its possible steps to the investor from the issuer. These chapters have fully described the process. "Secondary market" means the buying and selling of securities already in the hands of investors. Presumably from frequent appearance, the meaning of both phrases has become clear from the context in which they have been used.

INTERRELATION OF PRIMARY AND SECONDARY MARKETS

Syndicate participants have at times sold securities "investment guaranteed." On such a sale the purchaser, on a price concession, promises not to resell until the term of the syndicate has expired, and the member has no further responsibility for the bonds he has sold. Transactions of this kind have sometimes taken place on such a scale that buyers "investment guaranteed" have resold on the same condition, and developed a market quotation for sales on these terms. A price concession on an "investment guaranteed" sale seems clearly to violate the terms of the syndicate agreement, and if done in the future will also violate the rules of the Code of Fair Practice.

Very likely a restriction of this kind on resale also violates the laws against restraint of trade. In the last respect, however, perhaps the syndicate participant could achieve his end, without conflicting with the law, by selling with a delivery deferred until the close of the syndicate.

Generally speaking, however, sales by investors — the secondary market — may arise immediately after the syndicate begins selling. Though this secondary market may interfere with the syndicate operation, which must support the price, nevertheless

the bankers may nourish it, and make every endeavor to build it up so that it may become self-sustaining immediately on the close of the syndicate.

Ready marketability adds an element of great value to a security. Conversion of interests in fixed assets to a type of property quickly liquidatable into cash makes an important contribution to the welfare of a society based in its economic organization on the private ownership and management of wealth. It enables men to put quickly into effect their judgments of risk, and makes control over wealth adjustable to changing individual needs. Investors will pay for this element of value. They buy new issues of large size in the belief that they are the kind of issues in which an active secondary market will arise. Bankers need to satisfy this expectation as a basis for continuing to bring out new issues.

Quality of a market in securities depends on the speed with which a transaction can be effected, and the difference between the bid and asked prices. A market can exist only when there is a seller willing to sell at a price, and a buyer willing to buy at a price; and a transaction can take place only when buyer and seller are willing to deal at the same price. The more widely apart the wills of buyer and seller, the longer it is likely to take for them to come together.

Under ordinary conditions an active stock listed on the New York Stock Exchange can be bought and sold within a few minutes. With a bid and asked from one-eighth to one-fourth apart, the seller can dispose of his stock with only that difference between what he receives and what he would have to pay for it. Opinion forces coming to a resolution in the market effect an appraisal. The owner of such a stock on selling knows that he gets the full appraised value.

On the other hand, with a difference of five points between the bid and asked, say, 90 to 95, in some unlisted security, a sale can be made quickly only by accepting the bidder's price, which is five points below what the seller would have to pay if he wanted to make a quick purchase. By taking time, the seller, through the haggling of the market, may effect a transaction at, say, $92\frac{1}{2}$. With such a security, however, it may take weeks for buyers and sellers to effect their compromise.

Months or years may pass before buyer and seller get together in a transaction for the transfer of a parcel of real estate. This

wealth does not possess the quality of fungibility necessary for an active market. No piece of real estate is exactly like any other. Though there may be various possible buyers, there is only one possible seller. With an issue of $3,000,000 of bonds in average holdings of $3000 there are one thousand possible sellers: if the issue is $30,000,000, with the same average holdings, the number of possible sellers increases to ten thousand. Since this human world daily demonstrates the truth of the philosophy of Heraclitus, that all things flow in the changeability of the affairs of men, among ten thousand possible sellers every day one or more will almost certainly want to sell. Investors become familiar with an issue of this size, and ready to buy at what they regard as a favorable price. Under these circumstances, if there were no previously organized markets for securities, one would inevitably rise.

With this preface let us consider the secondary markets in securities.

OVER THE COUNTER MARKET

If an issue of stock is listed on the New York Stock Exchange or on the New York Curb Exchange, practically all the transactions in the shares take place on the exchange. The bond market does not correspond. No statistics are available to show exactly the relative volumes of exchange and off the exchange transactions in listed bonds. But one gets the impression that the exchange market in such issues reflects the outside market rather than the reverse.

Aside from the process of accumulation already described, a banking house may do a little active speculating in bonds, not so much on the basis of substantially out of line prices as of quicker ordinary trading. In such business the performance of the banking house is much the same as that of the floor trader on the stock exchange, scalping quick profits out of slight price changes. Sometimes the difference between the banker's bid and asked price in this trading is less than the sum of the buying and selling commissions on the stock exchange. So, by dealing with the banker, buyers and sellers find an essentially closer market than on the exchange.

The banker may act as broker instead of, or as well as, trading on his own account. Besides those who resort to him of their own initiative for the closer, and perhaps quicker, market he

offers, some may come through the activities of salesmen who in their rounds find people who want to buy or sell securities not in the list of house issues the salesman especially wants to sell.

For this work, investment banking houses often have one or more traders. In addition to the business which comes to the trader through the salesmen, and from those who resort to the house of their own initiative, the trader himself develops business. Knowing where securities are held, i.e., knowing who owns blocks of certain issues, and knowing those who are interested in buying bonds of certain issue or types, is all part of his capital of information which makes him useful.

He must have a quick sense of the drift of the market. If he receives requests for two bid quotations and only one asked quotation on a certain issue, he feels the softening and guides himself accordingly. Always he must be alert and sometimes intensely at work. He has several telephones on his desk, and often he is holding one line while using another in the endeavor to effect a transaction.

In his feel for the market, he must realize that several inquiries may relate to only one block of bonds. Inquiries reverberate through the Street and sometimes about the continent. One trader wanting to buy or sell bonds calls up another; the one called does not want to deal on his own account, and has no orders to fill; but sensing a chance to do business, he calls up a third, and so the inquiry spreads. The echoes keep coming back to the trader, who in most instances can readily recognize that they are echoes, and not original inquiries. So the day's work of the trader goes. He is an interesting specialist in business.

Such security trading not on an organized exchange is said to be done in the "over the counter market." "Over the telephone" would be a more literal statement for most of it. It is substantially the only market for unlisted securities.

Rules of the Code of Fair Practice (Article VI, Sections 1–4), relating to this over the counter market, in substance require the banker to make clear to the customer whether the transaction is on the banker's own account or whether it is a matter of brokerage. If the banker is acting as broker, he must, under the rules, furnish the customer with information which would enable him to ascertain that the banker has fulfilled all the duties of an agent to his principal in the fiduciary relationship involved.

It should be noted that the Federal Securities Exchange Act

of 1934 provides for the regulation of this over the counter business by the Securities and Exchange Commission. Section 15 (a) states that:

> No broker or dealer (other than one whose business is exclusively intrastate) shall make use of the mails or of any means or instrumentality of interstate commerce to effect any transaction in, or to induce the purchase or sale of, any security (other than an exempted security or commercial paper, bankers' acceptances, or commercial bills) otherwise than on a national securities exchange, unless such broker or dealer is registered in accordance with subsection (b) of this section.

Subsection (b) provides the process of registration and for the denial or revocation of registration. The Commission may deny or revoke if it finds such action in the "public interest *and that*" the broker or dealer has done any one of a number of specific acts set forth. One infers that the Commission might find the commission of an objectionable act and still not find it necessary in the public interest to deny or revoke registration.

Subsection (c) provides that:

> No broker or dealer shall make use of the mails or of any means or instrumentality of interstate commerce to effect any transaction in, or to induce the purchase or sale of, any security (other than commercial paper, bankers' acceptances, or commercial bills) otherwise than on a national securities exchange, by means of any manipulative, deceptive, or other fraudulent device or contrivance. The Commission shall, for the purposes of this subsection, by rules and regulations define such devices or contrivances as are manipulative, deceptive, or otherwise fraudulent.

THE AUCTION MARKET

Though the auction room is hardly a market in the sense generally given the word, still securities, even active listed securities, are sometimes sold at auction. An explanation of this phenomenon may reasonably appear in a discussion of secondary markets.

Under some circumstances securities must be sold at public sale. If anyone — the world at large — may attend a sale and be a bidder, the sale is public. Since only members of the stock exchange may come on the floor for trading, a sale there is not a public sale.

One of the commonest situations requiring public sale arises out of the rights and duties of pledgor and pledgee. If stock, or anything else, is pledged as collateral for a loan, on default of the borrower the lender may realize on the collateral only at a public sale, unless the parties have expressly stipulated to the contrary.

Further, the pledgee must give the pledgor notice of the time and place of the sale.

These rights of the pledgor and duties of the pledgee afford the owner of the pledged securities one last opportunity to protect himself. If at the last moment he is able to come in and bid, he may prevent a sale at such a low price as to leave him still with a large amount of his debt to pay. He may at this last moment be able to bid up to the full amount of his debt, or even to bid higher in order to prevent the sale of securities at a price far below what he regards as their fair value. Though the pledgor has no funds himself, he may be able to stir up other possible purchasers to attend the sale and bid.

Marginal account business in stock exchange securities could not be carried on, or could be carried on only with great difficulty, if collateral had to be realized on at public sale. But these rights of the pledgor are not unalienable. He can waive them or contract them away. Stock exchange brokers require him to waive them as a condition of taking his marginal account. At the same time they take other waivers with which we are not here concerned.

But the loan may not be by a stockbroker, and the lender taking the collateral may not have bethought him to procure the waivers which would enable him to sell the collateral on the stock exchange, if listed there. Under such circumstances the lender must resort to the public market of an auction sale. From such a source we sometimes see the spectacle of securities which have an active stock exchange market nevertheless being sold at auction outside the exchange. Ordinarily on such a sale the security would bring just a little less than the current stock exchange price. Someone would bid it in and immediately sell on the exchange to make the differential. Those who are not familiar with the legal situations involved are sometimes puzzled at seeing an advertisement of an auction of active listed securities.

Sometimes another influence causes unlisted securities to be sold at auction, even though public sale is not required by law. A fiduciary, as an executor or administrator, may find himself holding securities which have no active market. He may prefer to close out his holding at an advertised auction to establish evidence that he obtained the best price possible or, at least, that he did not defraud his beneficiaries in the disposition he made of the holding.

STOCK EXCHANGE MARKET — LISTING ON THE EXCHANGE

As we have seen in connection with over the counter transactions in bonds, an organized exchange is not necessary for the development of a quick, close market. With modern facilities for communication, brokers can deal effectively without meeting face to face. An exchange, however, facilitates business in some respects, and provides a means for regulating it. Among other desirable things, it gives publicity to the volume of transactions and to the prices made. Investors and speculators feel more confidence in this information coming from an exchange than they would if it came without such supervision.

Listing on an exchange does not of itself create a market for securities. Buyers and sellers make a market, and an exchange does not supply buyers and sellers, but only a place for them to meet through their agents, the brokers. A small issue may be neglected on the exchange. Transactions may take place only at long intervals and with wide price variation. Even for small issues such transactions as do take place are published, and to that extent the investor is better off for the listing. But he expects any large issue to be listed. Unless the securities to be offered the public have been listed already, the bankers' circular regularly contains a statement that application to list has been made, or will be made, as the case may be. However probable that the exchange will list the issue, the bankers cannot absolutely promise the listing, for that depends on the action of the exchange authorities.

Listing means simply that the exchange will permit its member brokers to trade on the floor in the issue. But the fact that an issue has been accepted for trading indicates that it has complied with the requirements for listing, and furnishes some assurance, whatever it may be, to the investor of the quality of the issue.

Many of the larger cities of the United States have exchanges. And Canada has the Montreal and Toronto exchanges. American exchanges outside of New York City for the most part list relatively local issues. The great national institution is the New York Stock Exchange, with the New York Curb Exchange supplementing it through listing certain issues not listed on the "big board."

Our consideration of listing will confine itself to the require-

classification as to amounts held, and ascertains if holders are free from any agreement which would in any way restrict their selling. In short, it inquires whether, if the security is listed, a market will arise, and be such as to resist corners and other manipulation, and not be liable to violent price change caused by the dumping of large blocks.

AGREEMENTS WITH THE EXCHANGE — INFORMATION AND PUBLICITY

Corporations listing issues must enter into certain agreements with the Exchange. Among other things these agreements require a corporation to publish at least once in each year, and submit to stockholders at least fifteen days in advance of its annual meeting, a balance sheet and income and surplus statements. As a precaution against the information being misleading it must publish these statements in the form in which they appear in the listing application. Besides the annual statements, the corporation must publish periodical statements of earnings as agreed upon with the Committee. The Exchange recognizes that conditions vary in kinds of business and among enterprises so that a uniform rule for periodical statements might not be fair or workable.

The corporation must agree to notify the Exchange immediately "if it or any subsidiary or controlled company should dispose of its property or of any stock interest in any of its subsidiary or controlled companies, when such disposal would impair or materially affect its financial position or the nature or extent of its operations as theretofore conducted." Also the corporation must give prompt notice of "any change in the general character or nature of its business." This presentation of requirements for information and publicity is not at all complete, and is given merely to indicate their nature.

AGREEMENTS WITH THE EXCHANGE — FOR CONVENIENCE IN TRANSACTING BUSINESS

One of the agreements requires the corporation:

> To maintain, in accordance with the rules of the Stock Exchange a transfer office or agency in the Borough of Manhattan, City of New York, where all listed securities shall be directly transferable, and the principal of all listed securities with interest or dividends thereon shall be payable;

also a registry office in the Borough of Manhattan, City of New York, south of Chambers Street, other than its transfer office or agency in said city, where all listed securities shall be registered. If its transfer books should be permanently closed, to continue to split up certificates of listed stock into smaller denominations in the same name so long as such stock shall be retained upon its list by the New York Stock Exchange. If its transfer office or agency should be or should become located north of Chambers Street, to arrange at its own cost and expense that its registry office will receive and re-deliver all securities deposited at such registry office for the purpose of transfer.

An efficient carrying on of the work of the Exchange requires that the facilities for transfer be close at hand. Rules of the Exchange call for the delivery of securities in regular course on the second day after the contract of sale is made on the floor. The seller's certificate may be for a larger number of shares than he is selling. Or the sale of the shares represented by a single certificate may be to more than one buyer. Delivery could not be made in regular course if the transfer books were closed and the certificate held by the seller could not be split. The agreement does not prohibit the closing of the transfer books, but does require that, if they are closed, the certificate may nevertheless be split and two or more certificates issued in the same name.

On endorsement by the seller these split certificates become a good delivery. Such a provision for splitting does not interfere with keeping the transfer books closed in order to make up the stockholders list. Nevertheless, the Committee on Stock List recommends that a date be fixed as the record date to make up the list of stockholders entitled to receive dividends, allotments of subscription rights, and notice of stockholders meetings, without closing the transfer books. An interruption of transference interferes with the free flow of business.

INFORMATION ON LISTING

Fully to present and even briefly to discuss the requirements for information to be furnished with a listing application would be to review a large part of this book. It goes to the soundness of the business enterprise and the validity of the security. Besides the balance sheet and income account, the application must present much information to bring out the full significance of these formal financial statements. The Exchange calls for a re-

port of a qualified engineer covering actual physical condition of the property at a recent date.

Going to the validity of the issue, the Exchange calls for the charter, by-laws, authorizing resolutions, and so on. Also:

> Opinion of counsel (not an officer or director of the corporation) as to legality of (a) organization, (b) authorization, (c) issue, and (d) validity of securities. The Committee will not accept the opinion of an officer or director of an applying corporation nor of a firm in which the officer or director is a member, as counsel on any legal question affecting the corporation; nor will it accept the opinion of an officer or director of a guarantor corporation nor of a firm in which the officer or director is a member, on any legal question affecting the issuance of guaranteed securities.

This specific extract from the listing requirements has been presented to show the detail to which they go. But with all the detail, it will be noted that even this contains nothing to prove that the corporation has good title to the property set forth in its statement of assets. In the case of a bond issue secured by mortgage a complete statement of validity would include a statement of the validity of the lien which would include the validity of title. To certify to title of all the assets claimed by, say, the New York Central Railroad, would involve a more than Herculean task.

The situation illustrates the difficulties of complete precautions. Presumably the New York Central Railroad does hold good title to the assets it purports to own; and if there are any defects in the title to some parcels, presumably their values are so small as to be negligible in relation to the values of the enterprise as a whole. The matter might easily become serious, for example, in such a matter as good title to a mine. It would seem that in such a situation the Committee might well require some evidence of good title. But the Exchange is in no sense a guarantor of the securities it lists. If it exercises such care as is practicable, presumably it has done all that may reasonably be expected of it.

Seventh Section

Internal Financing and Corporate Income

CHAPTER XXXVI

Financing Production

We have heretofore considered permanent or long term financing. This section will discuss short term or current financing. Corporate form affects the long time transactions for which the stockholder and bondholder groups are brought together, but not the current operations. If we have stock or perpetual indebtedness, we may say that we have financing permanent in the sense that it lasts as long as needed, or as the business continues solvent. Since long term indebtedness endures for a relatively extended period, people often speak of it also as permanent, and we will do so when the word seems useful.

Excepting for that part of current operations which is never completely self-liquidating, permanent financing does not provide for them, but for the acquisition of relatively fixed assets. Conforming to the custom of the Street, we will most of the time, for convenience, drop the word "relatively" and say simply "fixed." Everyone, however, is quite aware that no assets other than land are absolutely fixed or permanent. Tangible things used in the enterprise wear out in time, and the process gives rise to the business problem of depreciation. Or the developments of invention make them no longer advantageous, and the problems of obsolescence arise. Intangible values are subject to diminution or loss through social change. Yet they are in the enterprise permanently as compared with the values which the enterprise produces. Values of produced things may be as permanently in the business as any of the fixed assets; but the things themselves are constantly converted into equivalences, and do not stay in the enterprise in any single form.

PRODUCTION, MARKETING, AND SERVICE BUSINESSES

Sometimes we classify enterprises into those rendering a service, and those producing and marketing goods. There are differences,

and the distinction is useful. The differentiation is made along the following lines:

A service business does not result in the delivery of tangible things to a purchaser.

A marketing or merchandising business results in the delivery, to a purchaser, of tangible things which the business enterprise has not changed in form.

A production business results in a change in form of tangible things which are delivered to a purchaser.

Underneath these differences, all businesses are alike in their endeavor to create a value. In so far as dealing with goods is concerned, a transportation enterprise, which is a service business, creates place values; a merchandising business creates both place and time values; a manufacturing business creates form values. An extractive industry, as agriculture or mining, is a production enterprise creating essentially form values. A telegraph or telephone business is a service enterprise, enabling men at a distance to communicate with each other as they desire to do.

In short, all business seeks to satisfy the desires of men, and thereby to exact or win compensation. Within the economic field, there are but two means to this end — land and labor. The single tax people are right in saying that land is a natural monopoly. The socialists are right in saying that capital is but stored up labor. The errors of both arise out of the conclusions they derive from these premises. Men must carry on their economic endeavor within the limiting frame of land and labor.

We are not, however, engaging in a discussion of economic principles, except as a statement of them may become necessary. That economic functioning for which we have already used the familiar term "current financing," we might conveniently call internal financing. The stockholder group forms, and it may cause the formation of a bondholder group or groups. Each of these groups has its rights and risks, and each member his share of these rights and risks. We may conceive the groups as creating the structure within which the economic activity goes on. Within the structure, the activity requires its further special financing.

Business customs have developed, differing with the type of activity carried on. So we see cash businesses and credit businesses. By a cash business we mean one which sells goods or services for cash. Such a business may buy goods, and services in some degree, on credit. But if it sells for cash, we think of it as

a cash business; and, selling for cash, it has presumably less need to buy with credit. A transportation enterprise may sell its services for cash paid by the consignor; or it may render the service, and, relying on its carrier's lien on the goods, collect from the consignee.

MEANING OF CREDIT

We will delay a little to consider what is meant by cash and credit. Whenever a thing of value, tangible or intangible, is parted with without antecedently or simultaneously receiving the equivalence in value (other than a promise to pay) which is to be received, we may say we have a credit situation. Property rights, developed in a social system based on individual ownership of wealth, are so intricate that it is difficult to simplify statements about them. But let us test a little this statement about credit.

If an owner sells goods, but retains possession as security until he receives payment of the purchase price, we say he sells on credit. He has not parted with the goods and will not until he receives payment. Nevertheless, he has parted with a thing of value; namely, title, the freedom to deal with the goods he formerly had. We say that he has sold on credit.

A workman agrees to work by the week for so much a day. He does not collect his pay until the end of the week. Yet he has been parting with value day by day, hour by hour, minute by minute. We do not say that he is working on credit. Essentially he is. The situation is the same with a carrier which agrees to carry goods and not collect until delivery to the consignee. The carrier may have security in possession of the goods, but this may or may not be equal to the agreed equivalence for the service. Though we would not ordinarily speak of the carrier selling transportation on credit, yet that is what it does when it first carries and then collects.

Business has for its purpose a flow of values. A service enterprise creates its rivulet of values entering into the stream. Values flow into a production of marketing enterprise, and flow out increased in volume.

FORM OF BALANCE SHEET OF MANUFACTURING ENTERPRISE

Let us consider the balance sheet and income account of an industrial enterprise as illustrating these ideas:

Assets

Property and plant	$25,543,357
Patents, etc.	1,421,139
Investments at cost	75,518
Cash	821,775
Inventories	5,110,886
Bills and accounts receivable	4,727,311
Deferred charges	510,065
Prepaid insurance	263,941
	$38,473,992

Liabilities

Common stock	$20,082,065
Accounts payable	811,396
Notes payable	2,500,000
Reserve for taxes	892,788
Reserve for depreciation	8,823,615
Other reserves	307,944
Surplus	5,056,184
	$38,473,992

Income Account

Net sales	$35,158,950
Cost of sales	27,580,384
Depreciation reserve	1,259,011
Maintenance	773,504
Net profit	5,546,061
Federal, State, etc., taxes	1,061,504
Other deductions	231,383
Net income	4,253,164
Dividends	2,393,170
Surplus	1,859,994

On the asset side of the balance sheet two items especially interest us at this point. They are (1) inventories, and (2) bills and accounts receivable. Let us consider each in turn. Inventories consist of supplies and raw materials, goods in process, and finished goods not yet sold. For the purpose of the enterprise raw materials consist of everything acquired for fabrication into the finished product. Though the materials, or some part of them, may be the finished product of some other business, they are the raw materials of this enterprise. In the process of fabrication, men labor on these materials and use the land, buildings, machinery, tools, and supplies of oil, coal, or whatever besides the raw materials is necessary in the production process.

PROBLEM OF FINANCING PAY ROLLS

While the labor of fabrication goes on, the business must meet its pay rolls. Though the workmen labor through a week without pay, and so extend a series of credits varying from five and one-half days to half a day, they do not ordinarily extend credit for any longer terms. Business always contains the problem of how long a time elapses between the day on which cash must be paid and the day on which cash is taken in.

We may consider the situation at the beginning of a manufacturing enterprise. Assume that the fabrication process requires three weeks. The business must pay out cash for three pay rolls before it can take in any cash. If it then sells finished products for cash it can begin to reimburse itself for cash paid out. But let us assume that it is the custom of the business to sell on sixty days credit. It must, then, find cash for pay rolls for eight weeks and four days longer, or for a total of eleven weeks and four days, without any reimbursement from the sale of goods.

PROBLEM OF FINANCING RAW MATERIAL AND GOODS INVENTORY

So far, we have mentioned only the problem of finding cash for pay rolls. But the manufacturing process requires raw materials as well as labor. If the business can buy its materials on the same terms of length of credit as those on which it sells its product, it still has a problem of finding cash for materials. Since the process of fabrication requires three weeks, the business will have to begin paying for raw materials that length of time before it begins taking in any cash for its product sold on credit.

All this, of course, is elementary. But the student inexperienced in the business process is liable to regard entries in the balance sheet and profit and loss account as significant in themselves, without any real thought of their origins, and to consider that business exists for the purpose of creating accounts instead of accounts existing for the purpose of showing the results of business.

Bills and accounts receivable are the property rights owned by the business representing goods sold (and presumably delivered). With respect to the productive process, to continue our metaphor, a business has some of the aspects of a pond filled by a brook flowing in at one end and drained by a brook flowing out at the other.

The pond is constantly full of water, but not the same water. So the business is constantly full of rights, but they are not the same rights. At one moment it owns finished articles ready for sale. When it makes a sale of the articles on credit, it parts with the rights of ownership and possession of the tangible things, and receives in their place the right to be paid for them. But the bills and accounts receivable are not cash.

Workmen will not take them in payment for labor. Those who furnish raw material and supplies will not accept them as satisfaction for the tangible things furnished. Such rights to receive payment do not give a sufficiently swift and certain control over wealth. So these bills and accounts receivable do not directly help in making necessary current payments. The business must continue to finance the process of goods entering into consumption, until it receives effective payment for them.

FINANCING BY RECEIVABLES

This brings us to the liability side of the balance sheet. To the extent that the business buys materials and supplies on credit, it defers the necessity for cash provision. The fact that our business chooses, under the stresses of competition and the compulsions of custom, to extend credit to those to whom it sells, is no concern of those from whom it buys. But corresponding stresses and compulsions cause the suppliers of materials and supplies also to sell on credit, and to the extent of that credit to finance our business.

Evidence of credits extended, either by or to our business, may take several forms. The vendor may sell and deliver the goods without receiving any paper evidence of the debt. The buyer enters the purchase, and the obligation to pay, on its books; and correspondingly the seller enters the sale, and the right to receive payment, on its books. If a dispute should arise as to the amounts, or the fact of the sale, either party can produce its books of original entry as evidential, and can compel the other to produce its books. But one party can claim that the entries of the other are not correct. Or a party served with a subpoena duces tecum, to produce its books, may say that they have been lost or destroyed.

Further, this nature of the evidence of the right to receive payment makes the right itself less vendible. If the obligor has equities in any assets, the right is a thing of value. Though the time for the buyer to pay cash has not yet arrived, perhaps the vendor

of the goods, needing cash immediately, can sell for present cash the right to receive cash in the future. The vendor can transfer his right to receive cash, evidenced in such book accounts, by an assignment. But the right rests on such imperfect evidence that the owner is at a disadvantage in making a sale.

In order to make these credit rights more vendible, better evidence may be sought in their creation. The signature of the buyer of the goods to some form of acknowledgment of indebtedness, delivered to the seller, makes the fact and amount of the debt easier to prove. Though such evidence is not absolutely indisputable, it is much more difficult to dispute. Consequently a credit evidenced in this form is much easier to sell for cash. If the paper promise to pay, or acknowledgment of the debt, does not satisfy the strictly formal requirements of a "negotiable instrument," it, like an open book credit, is transferable by assignment. But the one who claims the right to collect has evidence of the right over the signature of the debtor.

If the paper promise to pay satisfies the formal requirements of a negotiable instrument, then the evidence becomes even more difficult to dispute, and consequently more vendible. Since this is not the place to enter on a consideration of the law of negotiable instruments, we will let the statement stand as a fact. So the vendor of goods may require the buyer, who asks for credit, to evidence the debt by a note or a bill. If the evidence takes the form of a note, it is a direct promise to pay to the seller or his order the stated amount. It might be, but in practice would not be, a promise to pay to the bearer. If the evidence takes the form of a bill, it is an order by the seller to the buyer of the goods to pay for them at the stated future time. This order is presented to the buyer of the goods for his "acceptance"; that is, for the buyer to write his name on it, in effect acknowledging the right of the seller to draw on him, and promising to pay at the time named. So the holder of such a piece of paper has the evidence of the debtor's signature. Since this is a negotiable paper, the holder can transfer the claim by endorsement. Moreover, the transfer is not affected by any rights of the debtor against the creditor of which the transferee had no notice.

For, aside from the unsatisfactory nature of the evidence of the credit in the case of the book account, here is another difficulty in selling such a credit for cash. On such a claim, if A owes B, it may chance that B also owes A, or has some other claim against

A, which B would have a right to offset against A, on A's endeavor to collect. In short, A's right may be subject to the limitation of B's right. By assignment of book credit, A cannot assign anything more than he has, namely, his right as limited by B's right. But if the evidence of the debt conforms to the requirements of a negotiable instrument, and the transferee is not on notice of B's claim, the transferee can take A's claim against B unaffected by B's claim against A.

Under European and British business practices sellers customarily draw bills on purchasers, which the purchasers accept. It should be remarked that if these accepted bills are further negotiated, the further transferee acquires rights against the two parties; a right to have the acceptor, who bought the goods on credit, make payment, and a right, if it is preserved by proper presentation for payment and notice to the drawer of default, to have the drawer of the bill, who sold the goods, make payment on default of the acceptor. Our language of the Street calls these accepted bills acceptances.

Some twenty-five years ago, or more, many people in this country extensively advocated the substitution of acceptances for book accounts, but with incomplete success. Debtors prefer not to have the claims against them transferred to third parties. If the debtor wants an extension of time at maturity date, such third parties are likely to be more difficult to deal with than the original creditor. The transferee of the credit is looking only for his money; the original creditor is likely to hope for further business, and in that hope to want to keep his debtor on good terms.

General adoption of acceptances in this country would make for sounder business. It would be well if more debtors were conscious that they would be expected to honor their promises in accordance with their terms, and could not expect to shilly-shally over payment. But just as the extension of credit at all arises out of competition for business developing into custom, so the same forces impel the vendor of goods to sell on book credit, instead of insisting on the acceptance of a bill. He is probably conscious that, in his turn of being the debtor, he does not himself want to accept a bill.

The time lapse between the day on which cash must be paid by a business, and the day cash is received in the business, we have seen is likely to be bridged, or financed, in part by purchases on credit. Presumably all of the item "accounts payable" on the

liabilities side of the balance sheet represents such a situation. It may be that some or all of "notes payable" likewise represents credit extended to the business by material and supply men. But maybe some or all of this item represents a different situation. If the notes are not payable to material and supply men, presumably they are payable to banks. And this brings us to bank credit as a means for the internal financing of a business. Sometimes the lending bank requires that title to the goods being financed be vested in it, whereupon it entrusts possession of them with the right of use and sale to the borrower under the terms of a trust receipt, in which the borrower acknowledges that it has possession for the benefit of the lender, and agrees to hold the proceeds of sale in trust to pay the lender. Legal ownership protects the lender against seizure of the goods by other creditors, and the proceeds are trust funds belonging to it. In this connection (and otherwise) the lender may make the loan in the form of granting a letter of credit under which those selling goods to the borrower may know that to the extent of the credit in the letter the bank agrees to pay for the goods on the designated delivery. All these arrangements are matters of commercial banking practice, and do not primarily concern us.

BANK CREDIT

We have already considered the service of banks in supplying temporary capital to business; and have discussed the problem of working capital to finance goods in the stream of production and consumption up to its low water level — that part of the flow which is constant in the sense that it does not fall below a certain minimum amount. So we will not here consider how large an amount of financing of a business a bank may do from the viewpoint of the fundamental principles, but only the method, and the amount as affected by other limitations.

A business resorts to banks for current financing to fill the gap between its own permanent capital provision and the amount of credit it receives from its material and supply men. But our banks do not loan on open account. They require negotiable paper to evidence the debt. European and British banking practice may to some extent permit overdrafts; that is, permit the bank to be drawn upon beyond the amount of the deposit credit balance of the business. Such overdrafts might be regarded as open accounts.

The business may give its own direct promissory notes to the bank to evidence the debt created by borrowing. If the business is fortunate enough to have customers' acceptances to evidence credits extended on goods sold, it may discount these acceptances at the bank.

Our earlier presentation of bank loans for current financing dwelt on the fact that the bank should not supply any of the capital required permanently in the business. If the bank did so, it would do violence to the nature of commercial banking, which essentially requires such liquidity that the bank could, without the lapse of any long period, turn all its assets into cash and pay all its depositors in full. The constant aim of commercial banking is, or ought to be, to get into and to maintain such a position. But the limiting condition that the bank should supply no part of the capital permanently required in the business may be fulfilled and still not afford an adequate assurance of liquidity.

The balance sheet presented shows cash, receivables, and inventories aggregating $10,659,972; and accounts and notes payable aggregating $3,311,396. Let us make the assumption that "notes payable" all represents bank loans. A reduction of current assets to $7,348,576 would pay off all current liabilities, and of course get the business out of the bank.

It may be that $7,348,576 represents the minimum of current assets, and that the business needs that amount of working capital financed by capital securities. However, let us assume that at the ebb of the year current assets in the business amount to $4,000,000. Under such circumstances bank loans could have increased above the $2,500,000 carried to $5,311,396, which with $811,396 accounts payable would make total current liabilities of $6,122,792. Though under these conditions the business at the ebb of its current assets would be out of the bank, nevertheless, the bank presumably would not be willing to extend its loans to $5,311,396.

A bank is not prepared to take the hazard that all current assets are good and liquidatable at their face amounts and book values. Some of the receivables may not be paid. The business may have to cut the price of its finished product without a corresponding reduction in labor costs. In that event the liquidation value of the inventory would not be so great as represented. The bank, to safeguard itself against these contingencies, by a rule of thumb, supported by the observations of experience, will not make loans

to such an amount as will increase the total current liabilities to more than one-half the total current assets. From this viewpoint the business represented by the balance sheet shown was in good condition. Its total current assets were more than three times its total current liabilities.

Ordinarily a bank does not require collateral for its current loans to business. The note of the enterprise evidencing the loan rests on the general credit of the enterprise. If the condition of the business were not such as to satisfy the requirements of a good general credit, conceivably the bank might make a loan under some circumstances secured by an endorsement, assignment of receivables, or pledges of raw materials covered by negotiable warehouse receipts.

Instead of relying entirely on direct banking accommodation, a business may utilize the services of note brokers. They sell the notes of the enterprise to banks not having a local demand for loans sufficient to exhaust lending capacity, or desiring to diversify their loans outside of the local risks. The credit principles involved are the same as those of bank credit we have discussed. Indeed, these loans through note brokers are bank loans. The only difference is that in the case of the note brokers the contact of the business with the banks is not direct.

SUMMARY OF THE PROCESS OF FINANCING PRODUCTION

Summarizing the productive process and its financing, we have:

A. Cash paid for
   1. Raw materials and supplies
   2. Labor

B. Creating before cash received
   1. Raw materials on hand entirely unfabricated, i.e., no element of labor value in them, and unused supplies
   2. Goods in process of manufacture
   3. Finished goods unsold
   4. Goods sold but not yet paid for

C. Until cash received financed by
   1. Working capital
   2. Credit extended by material and supply men
   3. Credit extended by banks

FINANCING A MERCHANDISING ENTERPRISE

If, instead of a manufacturing business, we have a merchandising enterprise, conducting, say, a department store, the essential elements remain the same, but presumably the proportions change. Such a business, instead of creating form values, creates place values and renders a service in changing large quantities received into small quantities sold. Instead of raw materials and supplies we have goods purchased (and supplies). We still have the element of labor performed, however, not in effecting changes in form of material, but in rendering the service of selling. The inventory becomes entirely one of finished goods. If the enterprise does business on credit, we have the same element of goods sold, but not yet paid for. Until cash is received the merchandising business finances its operations in the same way: (1) by working capital; (2) by credit extended by manufacturers or wholesalers of the goods sold to the retail merchandisers; (3) by bank loans.

BALANCE SHEET AND INCOME ACCOUNT OF A TRANSPORTATION BUSINESS

As the type of business done approaches a cash basis, the period between cash paid and cash received becomes shorter, and the problem of internal financing relatively less difficult. For illustration we will consider the balance sheet and income account of a railroad.

Assets

Road	$324,729,381
Equipment	126,050,912
Investments in affiliated companies	9,149,050
Other investments	31,099,720
Miscellaneous physical property	4,011,325
Cash	7,331,406
Loans and bills receivable	40,267
Accounts and balance receivable	2,840,960
Other current assets	186,773
Materials and supplies	10,218,722
	$515,658,516

Liabilities

Preferred stock	$22,992,300
Common stock	140,288,300
Funded debt	112,980,800
Accounts and wages payable	4,262,781
Miscellaneous accounts payable	294,375
Interest matured	39,674
Dividends matured	13,356
Accrued items	1,782,413
Other liabilities	3,324,688
Deferred liabilities	14,505,437
Accrued depreciation	43,962,206
Tax liability	6,493,639
Profit and loss and surplus	164,418,547
	$515,658,516

Income Account

Railway operating revenues	$106,947,111
Maintenance	35,408,277
Transportation, traffic, and miscellaneous	31,113,419
Railway tax accruals	9,200,000
Uncollected railway revenues	7,271
Net equipment and joint facility rents	2,985,913
Net railway operating income	34,204,057
Other income, net	1,799,629
Balance for interest	36,003,686
Interest, etc.	5,173,652
Net income	30,830,034
Dividends	919,692
Balance to profit and loss	29,910,342

Since items of both receivables and payables appear, the enterprise obviously does not do its business on an absolutely cash basis. But the railroad with more than ten times the assets of the manufacturing concern (both accepted at their book value) and with operating revenues three times the total sales of the manufacturing business has payables of $4,557,156 and receivables of $2,881,227 as against the respective items of $3,311,396 and $9,838,197 for the manufacturing business.

CHAPTER XXXVII

Deductions from Gross to Arrive at Net Available for Capital. Interest and Dividend Payments

We will now approach the problem of the internal finances of a business from a different angle. Assuming the goods sold, or the services rendered, producing certain ultimate cash receipts, we will consider the disposition made of these receipts. As we have seen, it is largely determined before they are actually received, so that when received they go to pay debts created in order to arrive at the point of cash. We will now neglect the pools of short time debts and credits, and the problem of bridging the period between cash paid and cash received. We will consider received cash and observe various dispositions that must be made of it in the course of conducting operations.

VARIABLES OF THE INCOME ACCOUNT

Enterprisers cannot count on gross receipts as a constant. In the chapter on capitalization we have already considered their variableness. Excepting that it was necessary to discuss it in that connection, this would be the logical place to set it forth. We will consider as read into this chapter all that was said there about variations in the gross intake.

RAW MATERIALS PRICE VARIATIONS

But the business man finds himself dealing with variables not only in his gross intake, but also throughout the entire scope of his enterprise. For illustration we will continue to use manufacturing as more comprehensive than any other one type of business. The manufacturer, at the beginning of his function, must buy the raw materials which he is to fabricate into his finished product.

Prices of such materials, however, do not remain constant. If the manufacturer could maintain a constant relationship between the price he receives for his finished goods and the price he pays for his materials, his lot would be much easier. But he often finds that, having made his goods out of material purchased at a given price, expecting to be able to sell his product at a certain price, he cannot obtain that price. Sometimes he happily finds that he can sell for more than his anticipated price.

Some industries (as, for example, those making rubber goods), owing to the distance of the markets or other reasons, must buy their materials long in advance of the sale of the finished product, and must maintain large inventories. Such conditions accentuate the hazards of price change. Conditions may tempt a manufacturer to speculate in his inventories; that is, anticipating an increase in the price of materials, to buy more than the quantity necessary to have on hand for the normal production process. This going outside of the necessary manufacturing hazards seems to have some justification in a business in which the manufacturer anticipates that he will not be able to adjust his finished product price quickly to the changing price of materials.

It may be that a manufacturer contracts to sell his product substantially ahead of delivery. Under such circumstances a contract for the purchase of materials sufficient to fill the contract for the sale of goods becomes an appropriate hedge against price change. In this way, millers and textile manufacturers often hedge in their raw materials markets. Or the hedge may take the form of a sale on the commodity exchanges for future delivery. The manufacturer is "long" of the material he has bought. If the price declines he may have to adjust the lower current cost of raw material into the selling price of his finished product and suffer a loss. By hedging through a contract, however, he will deliver on his contract at a profit to offset his loss as a producer. By so doing he abandons the chance of gaining advantage from a rising cost of inventory material and confines himself strictly to the compensation for his manufacturing service, because he will lose on his hedging contract if the commodity price rises. Of course a manufacturer seeks to adjust increased price of material into an increased price for his product. Under the economic organization of our society in the past we have relied on competition to compel him to make a like adjustment for decreased material cost, and to prevent him from unduly increasing his finished goods prices.

WAGE VARIATIONS

Wages present a corresponding variable of the income account. Likewise the manufacturer endeavors to adjust increased pay for labor into his finished product price. Many readers will be familiar with the price cycle experience in this respect. During a period of lessened demand and falling prices the labor costs do not fall as rapidly as prices, and capital absorbs losses; on the contrary, during a period of increasing demand and rising prices the wage scale may lag and capital tend to obtain larger returns. Many discussions of the fairness of returns to capital fail to take into consideration the long run; and fail to compute into an average the losses as well as the gains, losses not only of income, but of principal.

Though the topic is not within the scope of this work, the writer cannot refrain from interpolating a comment on the fallacy inherent in the widely disseminated idea that increases in the wage scale increase aggregate purchasing power, and provide the necessary means for utilizing the potentialities of productive capacity. Wages enter into costs, and in the long run costs must enter into price. To the exact extent that costs and consequent prices increase, the purchasing power of buyers declines.

Those buyers who have not had increases in income cannot purchase as much of the quantity units of those goods which have had their prices enhanced by increased labor costs. If all wages increase proportionately, the increases result only in a higher price scale. To the extent that wage costs are not adjusted into prices, those who provide the capital suffer diminution in income and consequent decline in ability to purchase.

It is probably true that men with incomes, from all sources, of $25,000 or more per annum tend to commit to capital additions a larger proportion of their incomes, and consequently a lesser proportion to current consumption, than men with incomes of $2500 per annum and less; and probably it is also true that a larger proportion of incomes of $25,000 and up per annum are derived from returns from capital than of incomes of $2500 and less. But at a time when capital receives no returns, or greatly reduced returns, men with control over wealth do not make commitments to capital additions, whether or not they are consuming up to their full income capacity. It has been the experience of the past that depressions have gone through a period of declining price

levels, presumably tempting those who have the ability to spend to increase the volume of their purchases to an amount which in cost more than offsets the decline in price.

COMPENSATION TO MANAGEMENT

One item of deductions from gross presents almost an especially corporate problem, the compensation of the management. It is difficult, perhaps impossible, to determine how much of the rewards of enterprise ought to go to capital for the benefits of its use, and its bearing of risks, and how much ought to go to those who manage the business. Capital as such is highly competitive, and apart from risk could not get more than a fair return. But risk is always present; and on the argument of risk borne, those who supply capital may claim compensation to almost any amount. On the other hand, management may argue that a relatively small return adequately compensates for the risk, and that returns in excess of this should go to management.

If the ability of managers were as susceptible of measurement as the ability of wage earners within each class of employment, it might seem that in our economic organization competition for executive skill would fairly determine its rewards. But in fact our large corporations tend to become oligarchies of managers. The corporate group of stockholders, who own the enterprise, do not hire and fire. Stockholders may send to their management the solicited proxies, which may be voted for a directorate assuring a perpetuation of the managers.

In effect, the managers can elect directors, who then go through the form of reappointing the managers. Such a directorate is likely to think well of its executives, and to treat them kindly in the pay roll. Though John Smith, the president, most properly withdraws from the meeting when the board acts on his salary, Henry Jones, the vice president, remains to help vote substantial compensation. On Smith's return to hear the good news and Jones's withdrawal, Smith is likely to feel in a generous mood, and ready to help his fellow creature on the path to rewards almost as gratifying as the Thistle, or the Garter, or the Bath. We need to find some way by which directors in fact represent stockholders and do not essentially represent managers, so that we will at least have a real judgment of the value of the executives.

Often, besides a base salary, which remains constant, bonuses

to executives give them additional compensation. The theory of the usual bonus is that a participation in profits gives an incentive to endeavor to create them, and a reward for bringing them about. Such a theory is a happy thought, but one feels that it is far from accord with the facts. Our economic cycles of the past have brought periods in which anyone having control of the instrumentalities of production could hardly fail to make a profit. Is the fact that in the late 1920's orders at desirable prices came flooding in on many of our corporate enterprises any evidence of skill in management? Yet a profit sharing bonus assumes that it is.

It would be absurd to say that during such years as 1932–35 bad management caused the huge corporate losses of those years, and therefore the executives ought to pay the corporations a reverse bonus. On the contrary, it well may be that during such a period the management exercises great ability in conserving values and keeping losses down. Yet one cannot feel sympathetic with the ethics of many who have not more severely cut their own salaries. They are the captains of the ship, the generals of the army. We admire those captains who, under stress of shipwreck, and those generals who, under the conditions of siege, reduce their own rations to the fare of their men, however much under other circumstances the captains and the generals may have indulged in champagne and terrapin. The crudeness of the approach to bonuses for executives contrasts with the great amount of thought which has been given to devising bonus plans for wage earning employees.

Provision for participation in ownership offers another way of special compensation to managers. Various devices are utilized. Shares may be set aside to be paid for out of their own dividends. The executive may have an option to buy up a stated number of shares at the option price. And so on. Under special circumstances any such opportunity for ownership may be useful. But the writer is of the belief that in the main it would be better to endeavor to arrive at a fair cash compensation. Participation in profits or in ownership commingles elements other than service.

MAINTENANCE

So far, the deductions from gross we have considered have been variable in the income account. We now come to two items which are, or tend to be, constants, or at least susceptible to

fairly accurate forecast. These are the items of maintenance and depreciation. Though the need for maintenance tends to be constant, at least in the sense of being calculable, so that the requirement for each year can be foreseen, actual allocations of income for maintenance may vary widely from such estimated amounts. It may be that from the viewpoint of the life of the asset a present expenditure for maintenance is called for. But it also may be that the asset will continue presently useful without such an expenditure, though the failure to maintain may reduce the life, or even impair, without destroying, present usefulness.

Still, with a given amount of cash available from the gross intake, and a choice between full provision for maintenance and default on a debt, probably no directorate would feel justified in suffering the default. We shall have more to say of this when we come to consider insolvent enterprises. Skimping maintenance in order to maintain a showing of earnings available for dividends is another matter. Here presumably the real interests of the stockholder lie in having the value of his asset conserved, quite aside from the possible questions of the legality of the dividends.

It is a common experience of the owners of buildings and chattels that the rate of required repairs is not an annual constant from the first to the last year of life, but tends to accelerate with time. So expenditure on this item increasing at a rate not obviously absurd need not arouse suspicion that the management is secretly ploughing in earnings so as actually to increase capital or surplus. The reverse, a decreasing rate of maintenance expense, does call for explanation.

DEPRECIATION

Since this book is not at all a work of accounting, we are not in the least attempting any full consideration of the problem involved in the income account. All we are endeavoring to do is to get a bird's-eye view of the internal finances of enterprise. When we come to the item of depreciation, we see that we have a situation with an essential difference from those already discussed. Here we do not have any present paying out of cash at all. As long as buildings and chattels are kept in such repair that they continue to be useful for their purposes, the enterprise can continue without any provision for depreciation. But the business man endeavors to maintain a distinction between prin-

cipal and income. And it is of the essence of corporate enterprise that the capital stock be not impaired. The useful life of buildings and chattels comes to an end. They cease to have value, or they have only the greatly diminished value of scrap. If the management fails to substitute any values in the enterprise, principal — i.e., capital — will suffer impairment.

Before the managers can arrive at a conclusion as to what part of the total values in hand is income, they must consider the value of total assets at the present point of time as compared with their value at the antecedent point of time from which they are computing, and see to it that the values paid out as income do not reduce the values retained as principal or capital. Replacements, or the substitution of an item of value which is new, to do the work of an item which is worn out or otherwise disposed of, may take care of part of the problem of maintaining values. Some enterprises come close to taking care of the whole problem in this way. As we have seen, a railroad with extensive lines and multitudinous items of equipment might make replacements take the place of any allowance for depreciation. With most businesses that would not be the case.

If the managers of an enterprise enjoy the experience of its increasing in magnitude, their problem is simple. The process of growth requires increasing values permanently in the business. Management applies some part of the gross current intake of funds to the acquisition of these additional values. It builds up the plant in part or entirely out of the gross earnings; and to indicate the decrease in value of the older assets, it sets up a reserve for depreciation.

Of course the management could make an annual markdown or write-off of the values at which it carries its depreciating assets in its accounts, substitute the other values equivalent to the markdown, and show no depreciation reserve. That would be logical and show the true situation by a direct method. But the convention of accounting handles the situation in the other way. And the convention has ample justification as furnishing the evidence of a visible accounting entry that the management has considered the matter of depreciation and dealt with it. Depreciation is a fact affecting values just as much as a money payment. Making elastic depreciation figures suit convenience presents an untrue account just as really as failing to enter a cash disbursement.

NON-RECURRING ITEMS OF EXPENSE

Expenses not in the normal course of business present one of the difficult problems of internal finance. Accountants endeavor to make their accounts serve several purposes: to show the distinction between principal and income, the ability of management, the state of health of the going business, and so on. We might well have several balance sheets and income accounts for an enterprise, each labeled with the purpose for which it is set up. For the purpose of distinctions between principal and income, capital and profit, the only question is of the existence of values. An item of expense is in itself a lost value, whether recurring or non-recurrent. On the other hand, it may be of such a nature that failure to recognize its non-recurrence would be to see an entirely false picture of the prospects of the business or the ability of the management.

INCOME AVAILABLE FOR CAPITAL

Gross receipts of an enterprise from doing business, as the payments for goods sold or services rendered, less the cost of doing business, constitute the amount of income available to compensate capital. Here we have the economic and political battle line between capital and labor. It is largely futile fighting. In the long run capital cannot get more, and will not get less, than it is worth in the most competitive of all markets, the capital market.

Apart from the question of the value of leisure in considerations of social welfare, the common economic advantage lies in the maximum production of wealth. There we have our primary economic struggle, the wresting, first of subsistence, next of comfort, then of luxury, from the physical conditions of the earth. It is the battle of man with nature. Society carries on this struggle in a form of economic organization, just as it continues a society in a form of political organization; carries on the economic struggle as a social group, and not as individuals. The advantages which capital gives in the war accentuate the tendency to organization in waging it.

With the primary struggle conducted in this organized manner, there immediately arises a secondary struggle of civil warfare within the group as to the proportions in which its members

shall share the spoils. This secondary struggle often disorganizes the primary one. What is justice? Must we be content with the wisdom of Thrasymachus, that justice is the will of the stronger, politically or economically? Whether it be justice or not, in practical effect, with ameliorations, that is what we have: whether in a given instance it be capital at the moment sweating labor; or management controlling proxies to vote itself large salaries; or labor, thinking it is unionizing against capital, in reality unionizing against other labor; or debtors by political endeavor in currency manipulation avoiding payment of value they have received. Assuming goods produced, the civil warfare as to who shall consume them promptly develops.

Use of a tool greatly increases ability to produce. And a tool is capital. The seeming amount of increase in production which appears in its use is in some degree deceptive to the heedless observer. If a man without a tool could produce values of $1000 a year, but with a $5000 tool, having a life of five years, could double his output, he gains nothing by the use of the tool. Its depreciation consumes the whole of the illusory increase. But tools generally increase production in a far greater ratio.

Is the man who, by refraining from immediate consumption, supplies the tool, justly entitled to the whole of its increase of production? If there were only one person to supply the tool, and one person to use it, the one who uses it might well be willing to give the greater part of the increase to the capitalist. The user, retaining ever so little of the increase, is by that much better off.

Capital, in the long run, at least, is highly competitive. Many are ready to supply the tool. In the ordinary process of capital accumulation, men refrain from consuming, at the moment, all they have the means to consume, in the hope of being able instead to consume in future what they might have consumed now. With men competing for tools to use, those who can supply them can obtain terms which create an expectancy that they will be able to consume more in the future than they can now.

But if there were more suppliers, or fewer users, it well might be that capitalists, for the value to them of future instead of present consumption, would accept an expectancy of a future return of less than they now have, if the expectancy were strong enough. We would have a reverse interest. The capitalist would pay $100 to the man who would, without other return, sufficiently

assure a return of $75 five or ten years away. This is no idle speculation. We have seen it: short term securities selling on such terms that the total amount returned was less than the amount paid. The highly competitive nature of capital is the one thing that creates what is perhaps a possibility of regulated monopolistic rates in the public utility field we have been experimenting with for about a third of a century. It is the competitive governor on the engine of such rate making.

And the market for capital supply is (generally) not national, but international. The competition of supply and demand here is a world competition. Some countries today, to be sure, in the course of our nationalistic retrogression in the wrong matters, are politically prohibiting, or limiting, the export of capital. None are limiting its import. It results, from the competition of capital seeking a user, that the supplier cannot get the greater part of the income which the use of capital creates. That part which it cannot get becomes the residue of the spoils wrested from nature, which the other members of the community struggle for among themselves.

Groups form in the internal struggle, and sometimes make alliances against the rest of the community. We see the manufacturer substantially assenting to a unionization creating a uniform wage scale in an industry, and removing a competitive element, so that an increased share of the product may go to the labor of that industry, and a correspondingly reduced share to the rest of the community. Since capital remains competitive after the labor group has become non-competitive, capital cannot permanently gain an increased share by its alliance. But its management gains a truce with its labor at the expense of the rest of society.

All this perhaps over elementary economics may seem out of place. Very likely it is too rough a combination of lines to create even a sketch in its attempt to indicate some of the causations which lie back of the internal financial processes of a business, which result in income available for capital.

INTEREST

By the effect of agreement, those who commit capital under the terms of a creditor contract have the first claim against income available for capital. This priority arises out of the nature

of the agreement rather than being an explicitly stated part of it. If the enterprise does not pay its creditors, they will take its assets away from the owners. The source of payment to creditors is not limited to income; payment may be made out of any assets to any extent that does not involve an insolvent enterprise in preferring one creditor over another. Owners have a moral obligation not to do that, and creditors who would be injured can prevent it. We will consider this further under the subject of corporate reorganization.

No question of impairment of capital stock arises. The payment reduces liabilities of the enterprise to the same extent that it takes values out of the enterprise. If the capital stock is already impaired, that makes no difference. It exists for the purpose of making payments to creditors, and payments to creditors are to be made in full up to the point of insolvency.

We commonly consider, if a corporation has $1,000,000 of first mortgage bonds, and $1,000,000 of second mortgage bonds, outstanding, that the first mortgage bondholders have a prior claim for the payment of interest. To the extent that this is true it arises out of a factual situation. If the enterprise fails to pay the second mortgage interest, the second mortgage bondholders will take the assets from the owners. Then, if the second mortgage bondholders fail to pay the first mortgage interest, the first mortgage bondholders will take the assets away from the second mortgage bondholders. When we arrive at our consideration of corporate reorganizations, the process will appear, and the matter become clearer.

As a corporation approaches insolvency, the directors may face the difficulties of a momentous decision. Shall they default with the result that in all probability the stockholders will lose their property, or will they run the hazard that by payment they are creating a preference of creditors, which they ought not to do?

DIVIDENDS

After satisfying interest claims, income available for capital may be used for one of two things: (1) to make up deficits in impaired capital stock; or (2) for the payment of dividends to stockholders. This brings us to a somewhat complicated subject. We will see that the generalization we have made as a corporate principle, namely, that the directors must not voluntarily do

anything to impair capital stock, can stand only as an expression of a corporate idea of what ought to be a principle in practice, and as the actual principle adopted in many jurisdictions.

We will follow the summarized generalization made by Joseph L. Weiner of the law of dividend payment.[1]

He divides jurisdictions into four classes with respect to the law of dividend payment; those in which:

(1) No dividend may be paid while the corporation is insolvent or which will render it insolvent.

(2) No dividend may be paid unless the net value of the remaining assets will be equal to some predetermined figure (the impairment of capital provision).

(3) No dividend may be paid except from the balance of earned and hitherto undistributed profits.

(4) No dividend may be paid except from current profits.

It is apparent that only those jurisdictions falling into the second class satisfy our principle that directors must not voluntarily do anything to impair capital stock.

PROVISION THAT DIVIDENDS MAY BE PAID UNLESS THEIR PAYMENT WILL IMPAIR CAPITAL

Jurisdictions (a) may rest with the simple provision that corporations may pay dividends unless the payment impairs capital; or (b) they may add the further requirement that dividends may be paid only out of earnings or profits. We will consider each of these subdivisions of jurisdictions which accord with our principle.

WRITE-UPS

Whether or not capital stock is impaired depends on the aggregate values in the enterprise. If this aggregate of values, less the creditor liabilities, equals or exceeds the capital stock, then it is not impaired. Existence of values is a matter of fact. A corporate balance sheet presents an accounting statement. Let us assume that it is made up on the customary accounting conventions: of carrying fixed assets at cost; current tangible assets at

[1] Joseph L. Weiner, "Theory of Anglo-American Dividend Law: American Statutes and Cases (1929)," *Columbia Law Review*, Vol. 29, p. 461; also, same author, "The Amount Available for Dividends Where No Par Shares Have Been Issued (1929)," *Columbia Law Review*, Vol. 29, p. 908.

cost or value, whichever is the lower; notes and accounts receivable at their face amount, with a reserve of an amount which it is estimated may not be paid.

Such conventions contain a possible substantial discrepancy between values stated on the balance sheet and values in fact. A management, limited in dividend policy by a requirement that it must not impair capital stock, may engage in a process of revising the balance sheet, if it deems that the facts of value warrant such a process. Ordinarily their opportunity arises out of the balance sheet figure for fixed assets. In a period of a rising price level, the opportunity may exist for most enterprises to write up — i.e., increase — the balance sheet figure for fixed assets. And a particular enterprise may be able to find that its land value, or some other value, has increased, though there has been no rise in the general price level.

A write-up policy carries with it a danger for the management. Since values existing are a matter of fact, they may decline again after the write-up. If the accountant's conventions do not bind the directors, and prohibit them from writing up assets, neither do they protect a dividend declaration, when the values in fact do not equal the figures on the balance sheet. Then the only recourse for dividend payment by a corporation in the type of jurisdiction we are considering, when in fact impairment exists, would be a proceeding for a reduction of capital stock. If capital stock can be reduced to a point at which the values in fact fill the measure, the foundation for dividend payment will exist.

Of course the same considerations apply to the test of solvency. In this connection Weiner says: "The test of solvency is rarely applied in actions either to restrain a dividend or to recover its amount from the stockholders who received it. On the other hand it is very frequently the test where the directors are sued, in accordance with statutory provisions, for having paid dividends while the company was insolvent or which rendered it insolvent."

Where a jurisdiction adds the test of profits to the test of non-impairment of capital stock, or of solvency, we have the distinction between any profits, no matter when made, and current profits.

TEST OF PROFITS

A jurisdiction which does not apply the test of non-impairment, but only the test of profits, does not come into accord with our

general principle. It seems to violate the fundamentals of the concept of capital stock as a protection for creditors offsetting the limited liability of the corporation. If a corporation may make payments, irrespective of the aggregate of values less liability to creditors, as long as any of the values existing arose out of profits in conducting the business, then all values may conceivably be paid out, until the corporation reaches the point of insolvency, where even a payment to creditors would be wrong as creating a preference.

PAID-IN SURPLUS

In the case of par value stock, a paid-in surplus creates no difficulty in the matter of dividend distributions. If impairment of capital affords the test, that is a matter of fact, irrespective of the origin of the values. An addition of the test of profits would, at first thought, seem also to dispose of the matter of paid-in surplus in connection with dividends. One would assume that profits can arise only out of the conduct of the business. Again quoting Weiner: "The few decisions in point are in conflict. The reasoning of the cases is extremely diverse. It has been stated that premiums received on the issue of shares are profit, and that they are not profit. It has also been stated that though they are not profit they may be distributed to the shareholders."

But in connection with the last sentence, "It has also been stated that though they are not profit they may be distributed to the shareholders," there is an intermediate situation. Though there be a requirement that dividends be limited to profits, and we insist that paid-in surplus is not profit, does this prohibit a payment to stockholders in the nature of a liquidation dividend, provided such payment does not impair the capital stock? Some jurisdictions would answer in the negative.

If, in a given jurisdiction, a paid-in surplus may be created in the case of no par stock, there seems to be no reason why any different principle should be applied to dividends in connection with it. In the chapter on no par stock we have already considered the problem of creating a paid-in surplus.

SOUND PRACTICE

Whatever the law of a jurisdiction, sound practice in connection with a paid-in surplus would preserve it as a buffer against loss,

unless, indeed, the management found it could make no reasonably good use of the values. There seems to be no reason against creating it within reasonable limits for the purpose of a buffer. With a paid-in surplus losses may be suffered, but on profits arising, they may be paid out in dividends instead of having to be used to make up an impairment in capital stock. Moreover, the balance sheet ought clearly to show the distinction between surplus values created by the contributor, and those arising out of profits, so that no one may be misled as to the profitableness of an enterprise.

Also the idea of coupling the test of profits with the test of non-impairment of capital seems sound, certainly for any distribution not clearly distinguished as a liquidating dividend. We will not delay to examine the state of the law in jurisdictions requiring the profits test, with respect to the payment of dividends out of profits arising from the sale of capital assets. In a jurisdiction in which the only test is non-impairment of capital stock, such profits could, of course, be paid out. But the source from which they come ought to be specifically indicated. There might be no business need for retaining such profits in the enterprise.

Another situation suggesting a question in the matter of dividends is the surplus which may arise on a reduction of capital stock. Principles applicable to paid-in surplus would seem applicable here. And if there is no reasonable use for the surplus in the business, a liquidation dividend would seem proper in principle.

STOCK DIVIDENDS

Chapter XXI gives some consideration to the matter of stock dividends, enough so that it is unnecessary here to go further into the matter. It may be appropriate to call attention here to something which perhaps belongs in the section on the concept of capital stock. Certain statutes provide that the capital stock of a corporation shall be, for example, the aggregate par of the par value stock, plus the amount allocated to capital on the issuance of no par value shares, plus such amounts as a resolution of the board of directors may transfer thereto. So it would seem that, by such transfer, the capital stock of a corporation having only par shares may be greater than the par of the issued stock. It is doubtful, however, if in practice allocations are made to

capital stock except to accompany the payment of a stock dividend.

DIVIDEND POLICY

When we were discussing the expansion of the corporate enterprise through the retention of earnings in the business, we gave some consideration to dividend policy; but we will here carry the discussion a little further. We there expressed a doubt of the desirability of forcing minority stockholders, through the failure to distribute earnings, to make what is essentially an additional capital contribution. But just what policy should a board of directors pursue?

Most investors like a continuity of dividends. An average of five per cent, resulting from five years of payments at the series of rates of nine, three, nothing, four, nine, does not suit them as well as an annual five per cent for the five years. They may be aware of the probability of the average. If they plan personal expenditures, however, on the basis of a ratio to total income, they do not like the burden of caring for reserves to even out their means for current payments. Besides, many people, otherwise fairly sagacious, who live well up to really available income, find it difficult to refrain from considering as available their receipts in the form of apparent income in any year.

It should be remarked that everything said in this chapter with respect to dividend payments should be read with the thought of the Federal undistributed profits tax in mind.

REGULAR AND EXTRA DIVIDENDS

Further, an uneven dividend rate places on the stockholder the burden of estimating the probable average earnings available for dividends, and the probable attitude of directors about distributions; and he is not in as good a position to do this as the board of directors, who know the fact of their own attitude, and occupy the vantage position of management in looking at the probability of earnings. Commonly boards, aware of this, and aware of the stockholder's interest in the matter, make a distinction between regular and extra dividends. In effect they say they estimate that the enterprise will be able to continue the regular rate; and by stating that any given amount of a dividend payment is an extra, they warn the stockholder that he must not assume a continued payment of the amount.

TAXATION AND DIVIDEND POLICY

Taxation presents a special interest of the stockholder in having dividend distributions evened out. If the income tax rates were not progressive, an uneven distribution would make no difference in the aggregate of taxes paid over a series of years. With the progressive rates an uneven distribution shoves the taxpayer in some years into the higher brackets.

Just to illustrate the matter, assume a man, with a personal exemption of $2500, who derives his entire income from a corporation, which might make its dividend payments either an even five per cent, or might vary them, as we have indicated, through the series of nine, three, nothing, four, nine per cent; and that he holds $300,000 of the stock.

At the even five per cent his annual income is $15,000. Computed on the Federal tax rates in effect on returns made for income received in 1934, his taxes on the even five per cent annual distribution would be as follows: Since all income is from dividends, and the corporation has paid a tax at a rate very substantially higher than the normal tax rate for individuals, he pays no normal tax. Income subject to surtax is $12,500, on which the annual tax would be $335, or an aggregate for five years of $1675.

With the varying dividend declarations we would have the following results:

Income at 9%	$27,000	Subject to surtax	$24,500	Tax	$1885
Income at 3%	9,000	Subject to surtax	6,500	Tax	105
Income at 0	000	Subject to surtax	000	Tax	000
Income at 4%	12,000	Subject to surtax	9,500	Tax	270
Income at 9%	27,000	Subject to surtax	24,500	Tax	1885
					$4145

So the uneven distribution would more than double his tax payments. Incidentally these figures illustrate the gross injustice of a progressive taxation which does not permit an averaging of income. It hits, among others, professional men of certain types whose income is likely to vary widely from year to year. It hits the promoter or author who may receive in one year his entire compensation for years of effort.

Assume further that the unhappy holder of the uneven dividend paying stock lives in the State of New York, which also has a progressive income tax.

On annual dividend payments of $15,000 his New York State tax at current rates (omitting the emergency tax, which is at a flat rate, and would not affect the difference in results) would be $300, an aggregate for five years of $1500.

With the varying dividend declarations he would pay as follows:

Income at 9%	$27,000	Taxed	$24,500	Tax	$780
Income at 3%	9,000	Taxed	6,500	Tax	130
Income at 0%	000	Taxed	9,500	Tax	000
Income at 4%	12,000	Taxed	9,500	Tax	190
Income at 9%	27,000	Taxed	24,000	Tax	780
					$1880

The New York stockholder would pay $380 more in the five-year period on the uneven distribution. The aggregate of Federal and State taxes on the even distribution would be $3175; and on the uneven distribution, $6025.

Although the Federal income tax statute has for years breathed fire and slaughter against unnecessary accumulations of surpluses, presumably their accumulation for the purpose of maintaining an even dividend rate would not have been deemed a violation of these provisions. Now we have the penalizing undistributed profits tax. This will be discussed in Chapter LVI.

CORPORATE RESERVES AND DIVIDENDS

Maybe a corporation could carry out an even dividend policy advantageously by reducing its amount of current financing in periods of high earnings. To the extent that it cannot do this it must become an investment company. Those corporations whose managements, with prescience, accumulated surpluses in the years 1924 to 1929, and employed them at the advantageous rates of the call money market, unhappily stimulated the gross over-speculation of the time. It is to be hoped that we will not repeat the experience. On the other hand, the continued distributions out of these surpluses did much to cushion the economic fall of the community.

In accumulating to even out dividends the corporation does for the stockholder that which, if the corporation instead made full current distributions, he ought to do for himself. Even without the tax pressure, it may be socially desirable for our corporations to go to a considerable extent in giving their stock the investment aspect of even payments.

DIVIDEND DECLARATIONS

Dividend resolutions follow much the same form shown in Chapter XXVI in the resolution for creating stockholders' rights to subscribe for additional shares, and might run as follows:

"Resolved that a dividend of five per cent ($5 per share) be and the same is hereby declared out of the surplus earnings of the corporation upon its outstanding capital stock, payable the first day of November, 1935, to stockholders of record at five o'clock of the afternoon of the 15th day of October, 1935."

Just as previously described for stock selling ex-rights, so stock sells ex-dividend on the arrival of the day when it can no longer be delivered in time for transfer before making up the stock list for the dividend.

FRANCHISES

Conduct which politically organized society permits to some, but not to all of the same status, it terms a privilege as distinguished from a right, which denominates the conduct permitted to all. It calls the grant of such a privilege the bestowal of a franchise. Since privileges granted differ in kind, the word "franchise" seems to many to have different meanings. A grant of the privilege of eminent domain, that is, to take and use property of another without the consent of the other, and on compensation which the other has not agreed to, is a franchise.

So a privilege to use the public highways for purposes not open to all, as for railroad crossings, to lay gas mains, to install the poles and wires of an electric lighting and power system, is a franchise. Not all people of the same status have the right to vote at public elections. Only those may vote on whom, by reason of fulfilling certain conditions, the political society confers the privilege; and the political group may change from time to time. So we speak of the privilege of voting as a franchise. It is not the nature of the thing granted which constitutes the franchise, but the grant of a privilege of any nature.

In this light, the significance of what we call the corporation franchise should become clear. It is the grant, to the group of incorporators, of the privilege of doing business in a manner not open to all men by reason of their membership in the political society.

Much has been written about mortgaging corporate franchises, with the general conclusion that the franchise to be a corporation is not a mortgageable asset; so that, in ordinary practice, the mortgage bondholders form a new corporation to take over the mortgaged property in foreclosure. The essential situation seems simple enough. The State granted this privilege of being a corporation to the group formed by the incorporators, and not to anyone else.

Incorporation did not confer on them authority to transfer the privilege. Every member of the group may change. Stockholders can sell their shares. But they cannot sell their privilege of being a corporate group. All this may seem a little metaphysical, but there is a distinction. Of course privileges may be granted under conditions which permit their transference — as patent rights. Though we do not use the word "franchise" in

connection with patents, they have the same nature of special privilege as the other grants we have mentioned.

CORPORATION FRANCHISE TAXES ORGANIZATION TAX

On this grant of the franchise to be a corporation the State levies certain taxes. Though they derive from the same source in ideas, they take different forms. In point of time an organization tax comes first. For example, as a condition of granting the privilege, Delaware collects ten cents for each $1000 of total capital stock authorized up to $2,000,000, and five cents on each $1000 above $2,000,000; and New York collects five cents on each $100 of par value of stock authorized, and five cents a share for each share without par value. In addition to the organization tax there may be certain fees; for example, in New York the filing fee for certificates of incorporation of ordinary business corporations is thirty dollars. But such fees may be considered as covering the cost of service and not as a tax.

ANNUAL TAX ON FRANCHISE TO BE A CORPORATION

After the initial tax at the time of incorporation, the State imposes an annual tax on the continuance of the privilege. Though this taxes the privilege to do business, and is imposed whether any business is done or not, the amount of it may depend, in one way or another, on the amount of business done. Delaware imposes on a corporation doing business an annual tax of fifty dollars on an authorized stock capitalization of 10,000 shares ($1,000,000 if a par value of $100) and twenty-five dollars more on each additional 10,000 shares of stock capitalization. If a corporation is not doing business, the tax is one-half of the amounts. It should be remembered that Delaware encourages people to resort to its sovereignty for incorporation by making it relatively inexpensive. New York imposes a minimum tax on the ordinary business corporation, of one mill on each dollar in face amount of issued capital stock, with a minimum of ten dollars.[1] This, it should be noted, is the minimum whether the corporation is doing business or not. If four and one-half per cent on net income is greater than this minimum, the corporation must pay the

[1] Since our endeavor is only to indicate principles, we are not delaying to consider in these illustrations the problem of no par stock.

greater tax. So the maximum tax may run to any amount. We might, then, consider the annual franchise tax as divided into two parts: one a tax on *possession* of the privilege of doing business in the corporate form; the other a tax on *exercising* the privilege. But the tax is levied as one tax, with the rate dependent on the conditions.

FOREIGN CORPORATIONS — PRIVILEGE TO BE A CORPORATION GRANTED BY ONE STATE. EXERCISE OF THAT PRIVILEGE IN ANOTHER STATE. TAXES BY THAT STATE

A political society (as one of the States of the United States) cannot grant authority to exercise privileges outside the territorial limits of its sovereignty. If Pennsylvania confers on a group the privilege of doing business in the corporate form, the group does not thereby acquire a privilege of doing business in Ohio, or anywhere outside of Pennsylvania, as a corporation. By an exercise of comity other States regularly do admit the corporations of any State to do business within their borders.

But the corporation must make an application to the foreign State for permission, and receive its consent. The corporation thereupon becomes subject to the conditions imposed by the foreign State on its doing business in that State. In form this is usually a license for granting and continuing the privilege. It seems clear that essentially we have a repetition of the original grant of the privilege: (1) to be a corporation, (2) to continue being a corporation, (3) to exercise the privilege of being a corporation. The foreign State, not requiring a *de novo* procedure, accepts the proceedings already taken in the State of incorporation; and on the basis so established, extends the privilege within its borders, with such taxation as it may apply on all three of the indicated elements. It may be remarked, for completeness, that if the Federal Government confers the privilege of being a corporation, the privilege is exercisable in each of the States of the United States.

FORMS OF TAXATION

We are not attempting here to draw the distinctions between a tax, an excise, and a license, but are denominating, in business men's language, as taxation every process (except fees and

charges which are direct compensation for a service rendered) by which the State severs wealth from private ownership for application to the public use. These differences have important bearings on the operation of taxation. But we are concerned only with the fact of taxation imposed by reason of the corporate form of enterprise; that taxation which is more than an unincorporated enterprise has to pay. Whether tax, excise, or license, this special State levy on corporations may be based on authorized capital, on capital stock, or on the "corporate excess"; or it may be an income tax. Except for "corporate excess" these terms explain themselves.

TAXATION OF "CORPORATE EXCESS"

Though arrived at in various ways, in general the "corporate excess" is taken to be the value at which the taxing authority assesses all the corporate securities less the assessed value of all the tangible property of the corporation. To show the situation concretely, suppose a corporation with $1,000,000 of bonds selling (and assessed) at par, and $1,000,000 of capital stock selling (and assessed) at 125. Assume that the tangible property of the corporation is assessed where it is located at $2,000,000. The securities of the corporation are assessed at $2,125,000. The State calls the $125,000 the corporate excess, and taxes it substantially.

We have two possibilities here. One is that the tangible property in the locality where the property lies may not be assessed at its full value. However, the market value of the securities reflects the full value of the tangible property of the corporation. So, in effect, property individually owned pays taxes only on the assessed value, which is less than the actual value; and the corporation, by reason of the tax on the corporate excess, pays taxes on the full actual value of its property.

The State professes to act on the other possibility in levying the tax. It is that there are certain intangible values in the corporation which a taxation of its tangible property does not reach. There are no such values, however, which may not equally be present in enterprise not conducted in the corporate form. The value of the securities in excess of the value of the tangible property comes from special skill in management or from good will. The State does not seek these out and tax them in the

case of individuals. Obviously the "excess" may represent both possibilities of origin, and may be partly the difference between assessed value and actual value of tangible property, and partly intangible values of skill in management and good will.

FRANCHISE TAX BASED ON INCOME

We may take the New York situation with respect to certain classes of corporations as illustrative of a franchise tax based on income. The State taxes the incomes of those corporations at the rate of four and one-half per cent. It should be kept in mind that the taxes we are discussing are not in substitution for ordinary taxes on property, but are in addition to such taxes. The State also has an income tax on individuals, who must include their dividends from both domestic and foreign corporations in their taxable incomes, and may claim no deductions or credits by reason of the income tax which the corporation pays. It results that all the four and one-half per cent is a tax on the corporate form of conducting enterprise.

FEDERAL INCOME TAXATION AS A SPECIAL CORPORATE BURDEN

Though interrupting our discussion of strictly franchise taxes, we will next consider Federal income taxation of corporations because it is an income tax, and as such has a connection with franchise taxes on income. It will be noted that the Federal tax is not a franchise tax. The statutory group does not derive its privilege of doing business in the corporate form from the Federal Government. The tax, however, based on a special Constitutional grant of authority to the Federal Government to tax incomes generally, in the form in which it is imposed effects a special taxation of the corporate form of doing business.

The Federal Revenue Act of 1934 (Section 13) imposes a tax of thirteen and three-fourths per cent on the net income of every corporation. Stockholders do not pay the "normal" income tax of four per cent on dividends received; that is, in effect they get the benefit, to the extent of four per cent of the dividends, of the thirteen and three-fourths per cent already paid by the corporation on its net income. But this leaves nine and three-fourths per cent paid on the incomes of enterprises in the corporate form which is not paid by unincorporated enterprise.

Presumably the primary purpose of this impost is not to levy a special tax on the corporate forms as such, but to procure government revenue from income which may be long delayed in getting into the hands of individuals so as to be taxable to them. If corporate income were not taxed to the corporation, but only to the stockholders after the declaration of dividends, the corporation might accumulate surpluses and indefinitely delay the payment to the stockholders. If the Federal tax laws endeavored to give to stockholders receiving dividends the full benefit of taxes already paid by the corporation, they would encounter a difficulty in dealing with the progressive rate taxation adopted as a principle for individuals. On a base of a normal tax of four per cent, progressive surtaxes run as high as fifty-nine per cent for the highest income bracket (Act of 1934). Full benefit of the tax paid by the corporation could be given to all stockholders only by making the tax on the corporation as low as four per cent, or making the normal tax for all taxpayers as high as the corporation tax.

Consideration of the undistributed profits tax and other aspects of Federal taxation of corporations will be given in Chapter LVI.

COMPARISON OF TAXES PAID BY ENTERPRISE IN CORPORATE FORM AND UNINCORPORATED ENTERPRISE

To give a specific illustration of the special taxation imposed on corporate enterprise, one must select a specific jurisdiction, and for this purpose we will consider the comparison in the State of New York, and assume a corporation having all its assets and business in the State; with $1,000,000 of stock authorized, issued, and outstanding; with an annual net income, after the taxation on tangible property, which the enterprise would have to pay whether incorporated or not, of $100,000. In addition to the initial fee of thirty dollars, on filing its certificate of incorporation and organization tax of $500, it would pay annually:

New York State franchise tax	$ 4,500.00
Federal income tax on balance of $95,500	13,131.25
	$17,631.25

Assuming further the entire available net income paid out as dividends, the dividend payments would amount to $82,368.76,

on which the stockholders would have the benefit of an exemption from the Federal normal tax of four per cent, or a total of $3294.75. The net disadvantage of the corporate form would be $14,336.50.

INCIDENCE OF TAXATION OF THE CORPORATE FORM

Such a special corporate burden would presumably be staggering, if the incidence of the tax could not generally be shifted to the consumer. To the extent that, in a given type of business, corporations compete with unincorporated enterprise, they cannot shift the burden. This would be the situation in, say, corporate chain grocery stores competing with the individual grocer. But many types of business now require such aggregations of capital as practically to be prohibitive to unincorporated enterprise. Presumably no relatively small capital enterprise could now compete successfully in the steel industry. If corporate enterprise competes solely with corporate enterprise, presumably taxation becomes a part of costs which it will be able to carry into price.

If the corporate form is not a necessary condition for massing capital, the business man may well consider carefully whether or not he wants to undertake its tax and other burdens. In the illustration presented, out of a total of $100,000 net income, $14,336.50 is contributed to government, which the enterprisers would not have to contribute if they could conduct the business as individuals in partnership. A lawyer cautions business men proposing incorporation about the special burdens of corporate taxation. Sometimes they heed the caution.

In actual practice the small group of enterprisers, all of whom actively engage in the business, mitigate the corporate tax burden by the salaries they take as executives, reducing the amount of corporation net income. The Federal tax law requires that these salaries shall not be excessive for the service rendered. But here is a leeway for opinion. And whether excessive or not, to the extent that the taxing authority allows them, they reduce the taxable income.

CLASSIFICATION OF TYPES OF BUSINESS FOR CORPORATE TAXATION

Commonly the State statutes do not levy on all kinds of corporate enterprise by the same provisions. An ordinary classifica-

tion would tax financial institutions, railroads, public utilities, and other business purpose corporations by differing procedures. Very likely the statutes further distinguish among financial institutions and apply different methods to commercial banks, trust companies, savings banks, and insurance companies.

In the same way they may separate telegraph and telephone companies from other public utilities. Corporations owning and operating real estate, as apartment and office buildings, may receive different treatment from other ordinary business corporations on the basis of the presumably heavy real property taxes they pay. We are not, however, attempting any exhaustive treatment of corporate taxation, but simply endeavoring to indicate the broad main lines of principle to show the part taxation plays in the general scheme of corporation finance.

DISTINCTION BETWEEN THE CORPORATE GROUP (THE CORPORATION) AND ITS MEMBERS AS INDIVIDUALS (SHAREHOLDERS) IN TAXATION

So far, we have not remarked on the distinction between levying on the group as a corporation and levying on the individuals who as shareholders compose the group, and have discussed only the levy on the group. But we will now consider the taxation of the individual shareholders as distinct from the taxation of the corporation as such.

It becomes our first problem to determine what jurisdiction can tax the shareholder. Some of the shareholders of a corporation may reside in the State which grants the corporate franchise; others may reside in other States. Which State can levy on the member of the corporate group because he is a shareholder in the enterprise? Apparently both States can levy. The answer depends on where the shareholder's *property* lies.

Property, in the case of a share of stock, consists of the *rights* of the stockholder to share in the benefits of the corporate enterprise. To carry on the reasoning processes by which law, regulating the affairs of individuals in political societies, extends its application to provide for situations as they develop, we must enter a literally metaphysical field. A right exists in relationship to something. We are not, however, concerned with the location of the thing, but of the relationship. Here we have the relationship of the shareholder who is located in one place to a corpora-

tion which is located in another. The corporation itself is only a relationship into which the individual stockholder enters. And a relationship as such can have no location. But for the extension of legal principles we assign one to it.

The State where the shareholder resides may maintain a claim that his rights as a shareholder are located where he is resident; the State which grants the corporate franchise may maintain a claim that his rights as a shareholder are located in it. And both jurisdictions have successfully maintained their claims. As we have already noted, the Supreme Court of the United States, in *First National Bank of Boston v. the State of Maine*, 284 U.S. 312, decided that for the purpose of levying an inheritance tax, the rights were located only in the State where the stockholder resided. Though the Court was careful to limit the scope of its decision to the inheritance tax situation, conceivably the principle may come to be extended to property taxes on shares.

If the State of the corporate franchise levies a tax on the stockholders, it of course does not have jurisdiction over the person of those who are non-resident. But on the claim that the non-resident shareholder has property in the State, it has jurisdiction to tax; and the State may consider the corporation as the agent of the shareholder to receive notice of the tax, and be required to pay it on his behalf. Obviously a State of incorporation levying a tax on all shareholders, resident and non-resident, in this way, does essentially the same thing as levying a tax on the corporation's capital stock and surplus. A State not claiming that the property right of all shareholders is located in the jurisdiction may levy in this way only on resident shareholders, and may require the corporation to pay the tax on behalf of its resident members.

As just indicated, not all States act on the greatest possible claims they could make. A State may not seek to tax the shareholders of its domestic corporations at all. Such a State considers that, in view of the tax it levies on the corporate group as such, it has no justification for taxing the members of the group as individuals on their share in the group rights. Another State may not tax shareholders of any corporation, domestic or foreign, knowing that their values in domestic corporations are already taxed to the corporation, and presuming that the values in foreign corporations are similarly taxed.

TAXATION OF MEMBERS OF A BONDHOLDER GROUP

As a general principle, only the State of residence of a bondholder may tax him by reason of his ownership. Here the rights are more definitely regarded as existing where the possessor is. We find the doctrine of *mobilia sequuntur personam* (movable things follow the person) less subject to breach than in the case of shares of stock. But if the bonds are secured by mortgage the jurisdiction in which the mortgaged property lies may consider them as representing the realty and levy a tax.

To tax both the actual economic wealth and also to tax the paper representative of that wealth, as a share of stock or a bond, imposes a burden on wealth owned in these representative ways that is not borne by wealth which is not held in such representative ways. This unfair situation arises out of a mental confusion of property and wealth. Property consists of rights in things of value and is not the things themselves. The corporate form gives rise to two sets of rights with only one value: the direct ownership rights of the corporate group owning the thing of value, and the rights of beneficial interest of the individual shareholder in the ownership rights of the group.

A corresponding situation arises on a mortgage debt. There is only one item of wealth, the mortgaged premises. But there are two items of property: the ownership of the premises, and the ownership of the debt secured by the mortgage. Under an unrelieved general property tax the State taxes all property at the same rate, with a result that wealth owned in the double representative ways sustains an undue tax burden. As the duplication of property has increased, the consciousness of this increased burden has grown. It has resulted in a tendency towards amelioration through the substituting of income taxes, and classified property taxes, for the general property tax on these representative rights.

INHERITANCE TAXES

Though inheritance taxes are in no way special taxes on the corporate form, they are mentioned here because of the question of situs, or jurisdiction, in which the transfer consequent upon death takes place. We have already noted the Supreme Court decision that for the purpose of inheritance the rights of the

stockholder could be located only in the State of his residence. It is said that the privilege of devolution or transfer by inheritance is what is taxed, on the ground that both transmission of property from the decedent and its transmission to the beneficiary are privileges conferred by the State. We have earlier denominated as privilege that which some, and not all, the members of a political society enjoy. But to the extent that the State permits inheritance to any, the State permits it to all. One feels that the law indulges in a good deal of what the unlearned layman might crudely call hokum in distinguishing "privilege" from "right," and utilizes it as a justification for something that society wants to do and will do, but, when doing, proceeds to rationalize its conduct.

In the chapters on form and transfer of corporation securities we have already noted the problem of clearing decedent's stock for transfer from the claims of the State tax departments, and the obligation imposed on transfer agents to require waivers from the tax departments as a condition of transfer.

STOCK TRANSFER STAMP TAXES

Quite aside from inheritance taxes on transfers of decedent's stock, the Federal Government and several States impose taxes on all transfers of stock which are within their jurisdiction. A special revenue stamp must be affixed to the certificate presented for transfer, or on a memorandum of transfer, if there is no transfer on the books of the corporation, but only a delivery of a certificate endorsed in blank. Here we may have an accumulation of such taxes on a single transfer. Since the imposition is not by way of a tax on the property, but an excise levied on the transfer, the Federal Government may, and does, impose it. Further, to make the situation concrete by illustration, if the corporation is one of the Commonwealth of Pennsylvania and the stock is transferred, that is, title to it changes, in New York, both Pennsylvania and New York may require the payment by affixation of stamps. Pennsylvania has jurisdiction over its own corporation to require as a condition of change of ownership of shares in its corporation that such a tax be paid. Since the act of transfer takes place in New York, that State has jurisdiction to require payment of its tax.

Eighth Section

Reorganization: Settling the Affairs of the Corporate Enterprise in Financial Difficulties

CHAPTER XXXIX

Receivership

PRINCIPLE OF EQUALITY AMONG CREDITORS

It may be taken as a general principle that a debtor, unable to meet his obligations as they become due, owes at least a moral duty to his creditors to prevent, as far as he can, one of them from obtaining an unfair advantage over the others. Yet, at law, each creditor has a right to pursue his remedies; to enter suit; to procure judgment; by levy of execution to cause property of the debtor to be seized and sold, and the proceeds applied to or towards the satisfaction of the debt.

In a business situation which on orderly liquidation would end in all creditors getting seventy-five cents on the dollar, the diligence of the self-interested creditor may result in his getting a hundred cents on the dollar, and others only fifty cents or less. Such a creditor may not only obtain an unfair share of existing values, but may destroy values that others might have realized. By seizing some asset necessary for the continuance of the business which the debtor carries on, the solely self-seeking creditor may force a termination of the enterprise, with the loss of what we are familiar with under the term "going concern" value.

How can the debtor perform his moral duty of keeping all his creditors on a basis of equality in the face of the legal rights of each of them?

Further, if the debtor cannot, or does not, proceed to fulfil his moral duty, how can a creditor, willing to be fair to his fellows, but desiring not to suffer from their selfishness, protect himself against their gaining an unfair advantage?

ASSISTANCE OF EQUITY

Already, in various connections, as in the concept of the mortgagor's equity of redemption, we have seen how, under our juris-

prudence, equity supplements the law in the total endeavor of our legal system for justice. We shall now see how equity comes to the aid of the debtor, who cannot meet the maturing claims of his creditors with cash in full, and enables him to carry out his moral obligation of seeing that no one of them enforces his legal rights to the injury of others. And we shall see how, correlatively, equity provides the means of enabling the fair-minded creditor to be fair, and at the same time protect himself against the unfair. It may be remarked that we are interested at this point only in showing the principle of fairness among creditors; at the moment, for simplicity, we are not taking into account lien and other priorities.

Since we are interested only in corporate debtors, we will confine our consideration to the corporate problem, and shall refer to individual debtors only as much as may be necessary to clarify the corporate situation.

GENERAL ASSIGNMENTS

An individual can do what he ought to do in protecting his creditors by making a general assignment of his estate to a trustee for their benefit. It becomes the duty of the assignee to administer the trust for the equal benefit of all. If a creditor does not assent to the assignment, present his claim to the trustee and prove it, the trustee distributes to claimants proving under the trust, and the non-assenting creditor can reach only what may be left. Equity assists the principle of equality to the extent of putting this much pressure on creditors to accept it. If a creditor comes in under the assignment, and in the equal distribution does not get paid in full, he still has a claim against the debtor for the balance, and may seek satisfaction out of property which the debtor may acquire after the assignment. Since we are interested only in the development of a principle, we are neglecting the operation of statutes affecting such general assignments.

Creation of such a trust fund by the assignment brings the debtor's estate of his existing assets within the jurisdiction of equity, enabling it to apply the principle of equality. Apart from legislation, equity can give this much assistance to the debtor who wants to perform his moral duty of seeing to it, as far as he can, that all his creditors get their proper pro rata of his assets.

FIRST BANKRUPTCY STATUTE: BANKRUPTCY ON APPLICATION OF CREDITORS

Legislation came fairly early into the situation of a debtor who was not meeting his obligations as they fell due. It came, to be sure, not with the idea, primarily at least, of fairness among creditors, but to assist creditors against debtors seeking to avoid the fulfillment of their obligations. For its picture of the sixteenth century debtor living on the ancient equivalents of champagne and terrapin at the expense of his creditors, we join those who have enjoyed quoting the preamble of 34 and 35 of Henry VIII Ch. 4 (1542).

> Whereas divers and sundry persons craftily obtaining into their hands great substance of other men's goods, do suddenly flee to parts unknown, or keep their houses, not minding to pay or restore to any their creditors their debts and duties, but at their own wills and pleasures consume the substance obtained by credit, of other men, for their own pleasure and delicate living, against all reason, equity and good conscience; be it enacted

and there follow the provisions for the proceedings in bankruptcy.

When such a condition existed, the debtor had committed an "act of bankruptcy," and a creditor could cause the debtor's assets to be brought into the protection of the court, which, of course, proceeded to deal with them on the principle of equality of distribution.

EXTENSION OF BANKRUPTCY TO DEBTOR APPLICATION

It was not until 1825 in Great Britain, and not until 1841 in the United States, that a debtor could seek directly, by way of bankruptcy, to cause that to be done which ought to be done, and in this statutory proceeding throw the protection of the court about his creditors. But what the debtor could not do directly, he might, nevertheless, accomplish indirectly.

COLLUSIVE BANKRUPTCY APPLICATIONS

He might procure a creditor to initiate the proceeding. Though the proceeding would be collusive, there was no reason why it should not be carried out. It was a collusion to prevent a wrong, not to cause one. Both parties to it were to be commended. In

short it was a mere procedural device; the only procedure available to procure that to be done which ought to be done. We call attention to the matter here because we shall have occasion to refer to a corresponding collusion in the course of dealing directly with our own subject of the corporation.

CORPORATE LIQUIDATION UNDER STATE STATUTES

We have already dealt with the process of corporate dissolution, the termination of the corporate life, or franchise, without especially considering the situation of a corporation unable to meet creditor claims against it. We described the usual course of the authorizing vote of the stockholders, the filing of the certificate of dissolution, and the publication of notice. With the end of the corporate life, the directors become trustees. Actually, by force of the statutory enactments, they are enabled to function "as if" there were a corporation, and to use the corporate name in acting; and presumably the stockholders can act, "as if" there were a corporation, to fill vacancies in the board, and possibly for other purposes.

If the trustee directors can promptly meet all obligations in full out of the corporate fund, of course no difficulties arise. And if they cannot, they are in the position of a trustee under a general assignment by an individual debtor. They are vested with a trust and are bound to observe the principle of equality. Equity has jurisdiction.

But this gives creditors only the incidental protection of the court. The fund is not in court, and its disposition is not under the direct supervision of the court from the outset. Corporation statutes of the several States, however, provide for a course of liquidation by which the corporate assets may be brought into court for administration by judicial proceedings. The bringing in may be voluntary, as, depending on the statutory process, by application of the corporation on vote of the required proportion of stockholders, or on their direct petition. Or it may be involuntary, on the petition of creditors. And, in either case, the court may continue the directors in control of the assets, or it may appoint a receiver to take possession of them. With the fund in court, the administration proceeds under direct judicial supervision.

BRITISH CORPORATION INSOLVENCY SETTLEMENTS UNDER THE COMPANIES ACT

Great Britain provides a process of settlement of corporate affairs under the Companies Act, and does not bring corporations under the scope of its bankruptcy act at all. Since jurisdiction under the Companies Act extends territorially as far as that under the bankruptcy act, there is no need of the extension of the bankruptcy process to corporations. The idea of the corporation as a creature of the State is fully preserved in the fact that the settlement of the affairs of the corporation, when it can no longer function, is provided for under the same statute that provides for its creation.

LIMITATIONS OF LIQUIDATION PROCEEDINGS UNDER STATE CORPORATION STATUTES. CORPORATION BANKRUPTCY IN THE UNITED STATES

But in the United States geographical limitations of State jurisdiction may hamper settlement of corporate affairs under the provisions of State statutes. By our Federal law, passed by Congress under its Constitutional power of bankruptcy, creditors can bring a petition of bankruptcy against a corporation; and since 1910 a corporation may go into bankruptcy voluntarily. However, a municipal, railroad, insurance, or banking corporation could not be petitioned into involuntary, or petition itself into voluntary, bankruptcy. As we shall see, an amendment made March 3, 1933, adding Section 77, brought railroads engaged in interstate commerce under the operation of the provisions it made for reorganization, and an amendment made June 7, 1934, adding Sections 77A and 77B, brought other railroads under the reorganization provisions. These recent amendments, however, refer to reorganizations, a continuance of the going concern, instead of liquidation, and we will not concern ourselves with them at this point.

We are primarily interested, to be sure, in reorganization. It is the course of settlement of the affairs of a corporation in which the assets have more value to continue the enterprise than they have as scrap. But we shall not understand reorganization unless we know something about liquidation. Reorganization begins as though there were to be a liquidation, then arrests the actual

liquefaction, and goes on from the point of stop. Or the situation might be expressed by saying that it is a special form of liquidation, which preserves going concern values.

BANKRUPTCY PROCEEDINGS HAVE THE RIGHT OF WAY

We should always keep in mind that the constitutional power of Congress to legislate in bankruptcy gives proceedings in the Federal courts the right of way in all matters which come under the Bankruptcy Act. If statutory proceedings of settlement have begun in the State courts, bankruptcy proceedings will supersede them as a means of settlement and take the corporate fund out of the State court. We must place one limitation on this broad general statement.

If the settlement in the State court has reached the point where, after the filing of creditors' claims, some have been allowed, their allowance amounts to giving them a lien on the fund. Since the operation of the Federal Bankruptcy Act invalidates only those liens obtained through judicial proceedings within four months of filing the bankruptcy petition, it results that the fund, having become subject to the lien of creditors, will remain under the jurisdiction of the State courts unless a bankruptcy petition is filed within four months of the allowance of the claim or claims.

IDEA OF CASH LIQUIDATION INHERENT IN THE ORIGIN OF BANKRUPTCY

A little while ago we used the word "liquidation" in contrast with the word "reorganization." This brings us to another aspect of our problem. Bankruptcy proceedings arose out of the need for a means of reaching and applying to the satisfaction of debts the goods of traders who were avoiding payment. Since stocks of merchandise could be sold in parcels and turned into cash without loss greater than is inevitable in any forced sale, a piecemeal disposition did not destroy values.

The situation is very different from that, say, of the assembled assets of a manufacturing concern, its buildings and machinery, valuable for their capacity to go on producing goods. Unless their use in production has become entirely uneconomic, their full value can be realized only by keeping the enterprise produc-

ing. Presumably the good will and going concern values of such merchants as "do suddenly flee to parts unknown, or keep their houses" (i.e., to dodge service of process) are not great. Though in bankruptcy we have gotten beyond the limitations of the idea of the essentially fraudulent trader, nevertheless difficulties arising out of its origin are still inherent.

GOING CONCERN VALUE

Dr. Johnson is reported to have said when acting as auctioneer for the tools of a deceased brewer: "Do not look upon these utensils as a mere collection of pots, pans and kettles, but as the potentiality of wealth beyond the dreams of avarice." Though the creditors of an industrial enterprise which is not meeting its obligations can seldom feel as optimistic as that, it is true that the essential values of the assets lie in their capacity, as assembled, to produce income. Still it is not the mere matter of keeping the assets together that presents the difficulty of settlement under the bankruptcy statute. They can be sold in bloc and to the representatives of a reorganization committee. But can they be kept producing, meeting the needs of customers, without interruption by the bankruptcy?

CONTINUANCE OF ENTERPRISE IN BANKRUPTCY

Our Federal act provides that the bankruptcy court may "appoint receivers or the marshals, upon application of parties in interest, in case the court shall find it absolutely necessary, for the preservation of estates, to take charge of the property of bankrupts after the filing of the petition, and until it is dismissed or the trustee is qualified," and may "authorize the business of bankrupts to be conducted for limited periods by receivers, the marshals, or trustees, if necessary in the best interests of the estates, ***"

It is presumably because of this idea that bankruptcy is intended to be essentially a process of liquidation, in the sense of terminating the business, that the statute excludes railroads from its operation. Public interest requires that railroads keep running. So until the adoption of Section 77 the statute made no provision for settling their affairs. Under the provisions just quoted an industrial concern can be kept running. But with a

matter before a possibly overcautious court such phrases as "absolutely necessary" and "for limited periods" may be restrictive of desirable freedom.

FURTHER DIFFICULTIES OF BANKRUPTCY SETTLEMENTS

When considering the development of our practice in settling the affairs of corporations unable to meet their obligations, we must always keep in mind that corporations could not become voluntary bankrupts before 1910. And difficulty beset a collusive practice. A defendant could be forced into bankruptcy only if he were insolvent and had committed one of statutorily designated acts of bankruptcy. So a petitioner would have to allege the insolvency of the corporation.

The statutory definition of insolvency may be something of a stumbling block. It is that "A person shall be deemed insolvent within the provisions of this act whenever the aggregate of his property, exclusive of any property which he may have conveyed, transferred, concealed, or removed, or permitted to be concealed or removed, with intent to defraud, hinder or delay his creditors, shall not, at a fair valuation, be sufficient in amount to pay his debts."

It is a high, wide, if not handsome, allegation for a creditor to make, that his debtor is insolvent under this definition. How does he know the worth of his debtor's assets at a fair valuation? For that matter, how does the debtor himself know? Since the statement is normally made only "on information and belief," the obstacle to a collusive proceeding it presented was probably not great. If the corporation can procure a creditor to make this allegation, the act of bankruptcy enabling the petition to go to adjudication is simple enough. The debtor may make a written admission of inability to pay his debts and his willingness to be adjudged bankrupt on that account.

Since corporations may now go into bankruptcy on their own procedural initiative, this difficulty in the way of a corporation wishing to settle its affairs in the Federal courts does not arise. A voluntary bankrupt does not need to be insolvent in the sense of the statute. Financial difficulties of corporations, however, did not begin with 1910, and certain practices to cope with them had then already developed.

BILL IN EQUITY

Railroads in financial trouble could not have their affairs settled in bankruptcy. They sought another path — that of a creditor's bill in equity. Other types of corporate enterprise found it convenient to follow the same course. Presumably the path marked by the new Sections 77 and 77B of the amended Federal Bankruptcy Act (1933) will be followed in the future. Since the steps to be taken are the same as those under a bill in equity, presumably the practice under the new sections will be substantially the same as that under the non-statutory equity proceeding. We shall not be able to understand the operation of the new provisions unless we understand the way things have been done heretofore.

GENERAL ASSIGNMENTS

Let us assume a corporation seeking a way out of its troubles. Could it assure fair treatment of its creditors by making a general assignment, as an individual could? A difficulty appears. As a creature of the State, the corporation could not terminate its existence without the consent of the State. And a disposition of all the assets with which it does business ends, for the time being at least, its fulfilling the purpose for which it was chartered. The fact that it ought not go on doing business in a way resulting in unfairness, and that the legal attacks of creditors would soon put an end to the enterprise anyway, was not enough to banish the metaphysical ghost of some jurisdictions.[1]

Courts feeling this difficulty failed to perceive the distinction between an actual termination of the corporate franchise and a disposition of the assets with which a corporation carried on its business. Though the assets are taken away, the corporate franchise continues; and that is what the State granted. The corporate life in that sense can be terminated only on a formal writ of quo warranto, or by statutory proceedings provided for the purpose. Good sense has prevailed, and corporations may make a general assignment. Still, such an act begins a liquidation proceeding, and does not present a way out for corporations

[1] *Robinson v. Bank of Attica*, 21 N. Y. 406; *Harris v. Thompson*, 15 Barb. (N. Y.) 62; *American Ice Machine Company v. Paterson Steam Company*, 22 N. J. Eq. 72.

which may not liquidate, as railroads, or in situations in which a going concern value ought to be conserved.

BILL IN EQUITY IN STATE COURTS

A corporation could cause its estate to be brought into a State court by a bill in equity, for actual administration by the court. This contrasts with the general assignment which causes it to be administered under equitable principles applied by a court on invocation. But there were various objections to this course. For one, the State court might be reluctant to take jurisdiction. It might hesitate to act in the face of the State statutes expressly providing for the statutory settlements of corporate affairs. We have seen that these were likely to be in the nature of liquidation proceedings, destructive of going concern values, which the debtor would wish to preserve for the benefit of all interested parties. Since the legislature had not expressly said that this statutory shelter was for only those corporations which had no going concern values, the court might feel that it was going contrary to the desire, if not the expression of the will of the legislature, in affording a shelter other than the one the legislature had indicated for the corporate debtor to take.

But corporations were pulled away from State bills in equity by considerations more powerful than the caution of State courts in warding the corporations off. With the expansion of corporate enterprises their affairs and assets were likely to lie in more than one State, and the jurisdiction of a State court could not reach outside its own State. So the corporate debtor looked towards the Federal courts. To be sure, any application to them for assistance would have to be made to a Federal District Court as the court of first instance, and that court cannot directly reach assets outside of its own district. But the Federal courts form a coördinated system under one sovereignty, and are more likely to be coöperative than the courts of different States. A petition originating proceedings in the Federal courts would naturally be presented in the district in which the corporation had its statutory principal office. We still have the problem of bringing the proceedings within the jurisdiction of the Federal courts. Its solution is an exercise in legal navigation. The course, however, became well charted.

BRINGING THE MATTER WITHIN THE JURISDICTION OF THE FEDERAL COURTS

A proceeding cannot be brought in the Federal courts merely because an applicant wants it there. No one can come into any court unless all the facts exist necessary to give that court jurisdiction. And the sovereignty of the Federal Government, including the jurisdiction of its courts, is limited under the Constitution. Among the various bases for jurisdiction is diversity of citizenship. If the parties to controversies are citizens of different States, the matter can be brought into a Federal court; when the controversy is once properly there, others needing to join, whose citizenship is not diverse from that of their adversary, can, nevertheless, come in.

However, even though the corporate debtor desires to perform its moral duty of conserving assets for its creditors and of protecting them in the principle of equality, it has no controversy on which to proceed against them. Each of them has a right to have the debt owing to him paid; the debtor has no rights against them, but only a duty to pay its debts. A railroad could not get into a Federal court even by the statutory way of voluntary bankruptcy. And a corporation which could go into bankruptcy voluntarily since 1910 might not want to enter on that proceeding with its slant towards liquidation.

So, if a corporation desires to bring its estate under the protection of the non-statutory general equity jurisdiction of the Federal courts, someone other than itself must make the application. Therefore the corporation procures some of its fair-minded creditors to make the petition. Of course they must be citizens of a State or States other than the one in which the debtor is incorporated. And the amount of the claim must equal or exceed $3000, the minimum on which Congress authorizes the court to take jurisdiction.

Obviously the proceeding is collusive in the procedural sense. The creditors who lend their names for the purpose are not vindictively hostile. They are juridically hostile, in the sense that they do have a claim which they want paid; but they are willing to be fair to other creditors. They ought not to endeavor for more than equality, and they ought to help conserve values for the benefit of others as well as themselves. Certainly the debtor ought to endeavor to conserve assets and to preserve

equality. Both parties have sought the only available procedural way of attaining these ends.

We do not say that the corporate management and its bankers may not have selfish ends to serve in seeking to gain the strategic advantage of a petitioner's control of proceedings. Very likely they hope to gain by the opportunity they acquire to map courses and steer. Undoubtedly the management hopes to get back into control of the corporate estate, and the bankers hope for a continuance of the corporate financing. Probably both hope for present profit as a result of control of the proceeding. If counsel fees, receiver's fees, and underwriting commissions can be gained, they may be rich prizes. Possibly sometimes bankers and managers hope to cover up matters they do not care to have disclosed. The record of some of these proceedings, and rumor off the record, arouse grave suspicion of unjustifiable self-seeking.

But the management turns the corporate estate over to the court. All with proper interest will have an opportunity to come into court and call upon it for protection. They need to be vigilant, and the cost of vigilance in time and money may be too great for the individual who is being injured to pay. It may be that no one threatened with the same injury will come forward to provide a rallying point for association in the protection of all.

But in the affairs of a corporate enterprise of magnitude, there are likely to be some, in each class of those affected, who have ability and abundant means. Still, social affiliation with those in the management and the bankers, a thing akin to class consciousness, and the hope of a continuity of business relationships, may lead them to disregard their direct self-interest in the immediate matter. Our organization of society works, alas! imperfectly; but a social reorganization would not remove the ultimate causes of its imperfections, and they would continue their influence to undesirable results.

PETITIONERS MUST BE UNSECURED CREDITORS

Those whom the management procures to sign the petition must not be secured creditors. If a creditor has security it may be ample to provide for his payment in full. He has his contractual right, and it is not inequitable for him to have, perhaps not immediately, but ultimately, the full benefit of the security. If it should be sufficient to satisfy his claim he would have no reason

for asking protection against the selfish diligence of other creditors, which might deprive him of the equality he ought to have. We have spoken of the petitioners as being fair-minded and not endeavoring an unfair advantage. And that is true. They come to the court, however, not primarily on the ground of benevolence, but because they have their own proper interest to conserve. Since secured creditors have that which may fully satisfy them when applied to their satisfaction, it does not clearly appear that they are in need of protection. It would be only after they had resorted to their security, applied the proceeds to their debt, and found that they were not fully paid, that they would need protection in the equality they ought to have in payment of the balance of their claims.

To be sure, it may be inequitable for them immediately to enforce their liens, because to do so might be as destructive of going concern values as any race of diligence on the part of the unsecured creditors. But petitioning secured creditors would not be the persons most subject to the injury, and the court may hear only those who need its protection. Though it is commonly said that the petitioners must be general creditors, this is so only in the sense that they must be unsecured. They may be debenture bondholders as well as holders of current liabilities of the corporation.

CORPORATION ADMITS THE CLAIM

Since the proceeding is, in fact, collusive, the corporation will not defend by denying the claim. The petition would not succeed if the debtor said it was not indebted. But the fact of indebtedness is a matter of law, and not a proper subject for determination in a court of equity until the court has acquired jurisdiction, which a mere claim of debt would not confer; and so far we are endeavoring only to find the foundation for jurisdiction.

A judgment creditor may come into court for such equitable protection as he may need, as in a conflict with the claims of others against the assets he is seeking to reach under his judgment. He has already proved his debt in a court of law. Since the standing of a judgment creditor before a court of equity is well established, if he has any need of protection, the petition of the creditor who has not reduced his claim to judgment has sometimes been spoken of as if it were a defective judgment creditor's petition, the defectiveness of which is waived by the admission that the claim is valid.

But in a true judgment creditor's bill the creditor seeks something, as the settlement of priorities, different from that which a creditor who has not reduced his claim to judgment is after, namely, to be protected in the equality he ought to have, and in going concern values, both subject to destruction by unrestrained suits at law of other creditors. It might be said that since the application of our petitioning unsecured creditors may be defeated by a simple denial of the claim, it would not be possible for the petitioner to succeed without the collusion of the debtor. But if the debtor has in fact no defense to the claim, the debtor has no right to deny; its verified denial would be false and subject those who made it to the consequences of falsehood.

To clear the procedural way completely, the corporation admits the claim, and consents that the relief prayed for in the petition be granted.

THE PETITION

Now that we have seen a way of getting before a court of equity with a petition that will not be rejected for defectiveness, let us consider its contents more specifically. It states that it is presented on behalf of the petitioners, and of all other creditors who may join and contribute to the expense of the proceeding. After setting forth the jurisdictional facts to show that the petitioners are properly before the court, in a matter appropriate for its attention, it asks:

That the court take control of and administer the estate of the debtors;

That the court ascertain the rights of the petitioners and all other creditors, and that it marshal the assets and ascertain the liens and priorities;

That it appoint a receiver to take possession of the property and operate it;

That it enjoin the corporation and claimants from interfering with the possession and operation of the receiver;

And ending with a prayer for such other and further relief as the court may find proper and equitable, it leaves the door open for additional proceedings "at the foot of the bill." [1]

When the court has granted the petition and made its decree, the corporate estate has become subject to the direct control and

[1] Example of petitions appear in R. Foster, *Treatise on Federal Practice*, Fifth Edition, Vol. III, pp. 2608–2626.

administration of the court; the means are provided for making the control effective, and carrying out the administration, including a continued conduct of the business. Let us consider these means in their several aspects.

WHO IS APPOINTED RECEIVER

Since the court has taken the responsibility of administration, naturally it decides through whom it will perform its duty. At the instance of the management and the bankers, those who have presented the petition (i.e., their counsel, who are acting for the management) may suggest to the court the names of those whom they would like to have appointed. Such names can be suggestions merely. The court would resent a too vigorous pressing of them upon its attention. Nevertheless, it may, if it wishes, adopt them. These receiverships are a part of the "patronage" of the court necessarily incident to its functions. It ought to keep free from political, social, or other influence in any way tending to keep it from making the best appointment possible for the administration of the corporate estate and enterprise.

Should the receiver be a business man or a lawyer? Since the receivership presents a situation more complicated with legal problems than the running of a business which is not under the stress of creditors' claims that cannot be met, it is expedient to appoint a lawyer. He, however, is not likely to have the training and experience especially to qualify him for running the business apart from its problems of law. If the court appoints a lawyer, he will have to employ those who can supply the operating and special business skill. And he will still be too much occupied with the business aspects of an extensive enterprise to perform all the law work connected with the receivership, and will be entitled to counsel. A business man as receiver will of course have to have counsel. Whether the receiver be business man or lawyer, he should be one whose name will win the confidence of those whose interests are affected as a man of integrity and ability. The court has the responsibility and will appoint someone who has its confidence. In the settlement of the matter it may designate either a business man or a lawyer.

It should always be kept in mind that the appointment of a receiver is merely incidental to the creditors' bill in equity — a device, however important, to enable the court to take the estate

in possession and to continue the running of the business. The receiver is merely the agent of the court.

THE INJUNCTION

Next we will comment on the injunctive part of the order. Herein lies the protection equity offers against the race of diligence. In effect it says to the self-interested, "Hold your horses." A mortgage bondholder or other lienor may ask, "What is the good of having rights if one is not to be permitted to enforce them?" Or, "Is anything a 'right' if the State will not come to the assistance of the holder?"

The answer of equity is, "We cannot deprive you of rights. We must eventually permit you to enforce them. But we should and can restrain you from enforcing them in such a way and under such circumstances that you would injure others who also have rights. Speaking broadly, a court of law can only consider each right as its possessor presents it, and it has no way of considering together the rights of entirely separate parties in relation to each other. In equity we have. You will not be injured while we are holding you back from exerting pressure to get your right. The entire fund available for its satisfaction is under our care. We are preserving values for your benefit as well as for the benefit of others." With this the bondholder or other claimant must be content.

A lay reader may next ask, "What prevents me from going to a court of law and asserting my right in spite of the equity court's restraining order?" In that event the litigant would be in "contempt" of the court of equity, and subject to punishment by it, even to the extent of being sent to jail. We see that the injunction is an essential part of the entire protective scheme of the creditors' bill in equity.

CHAPTER XL

Operation of the Enterprise by the Receiver

We now have the receiver appointed. He must enter upon his work of taking the corporate estate into his possession and carrying on the business. Continuity of operation is essential for preserving the good will or going concern values. But the Federal District Court which appointed him can vest him with authority adequate only to taking the corporate property within its own district.

ANCILLARY RECEIVERSHIP

If the corporation has property outside that district, a receiver must be appointed in each district in which assets are located. Application must be made therefor. We have already remarked that one of the reasons for bringing the original proceedings in the Federal courts is that they form a coördinated system. Though each District Court is, within its district, free from interference from the courts of other districts, nevertheless all the District Courts within a circuit are bound by the decisions of the Court of Appeals of the circuit, as well as being bound by the decisions of the Federal Supreme Court. Something exists a little stronger than the comity of the courts of different States. So there is less likelihood, in a Federal as compared with a State proceeding, of difficulty arising over the appointment, as ancillary receiver, of the same man who was appointed on the original application. In practice, the courts of other districts do regularly designate him. Such an appointment is almost necessary to a successful continuance of the enterprise.

CONDITION OF THE PROPERTY

Almost inevitably the receiver will find the property in bad condition. The corporate management will have strained every

resource to avoid defaulting on obligations. Only so can they preserve the ownership of the stockholders, and continue themselves in their jobs, free from the hazard of the probable appointment of someone other than one of themselves as receiver. That they should endeavor to preserve the property for the stockholders is perfectly right. The management represents the stockholders. Though it must not volitionally do anything to create a deficit in the capital stock, the payment of creditors does not do so. Neither does a failure of adequate maintenance, as long as the funds which are needed for maintenance are paid to creditors instead.

Failure of maintenance, to be sure, accelerates depreciation; but our law has not taken this into account as a volitional impairment of capital. So it is entirely natural, and proper enough, for the management, by failing to maintain the property, to squeeze dollars out of it for the payment of creditors. And, given the opportunity, the management will do so, to the very point where, unless something is expended on the property, it will no longer operate. Sometimes, to be sure, disaster comes so swiftly, as in the sudden fall of inventory values in 1921 and 1932, that the management has no time to apply the squeezing process. Generally the receiver finds himself in possession of a property so badly run down that it cannot be operated much longer unless something is done to it.

CREDIT IN RECEIVERSHIP

Herein lies one of the great conserving possibilities of a receivership. The corporation could not meet its maturing obligations out of earnings. It had no credit with which to pay them by contracting new debts. The receivership immediately stops the pressure of claims by suspending them temporarily. Those which arose out of the corporate operations do not have to be currently met. Their drain in income from operation stops. A receiver makes a fresh start. He has a plant, however run down, which in effect is free and clear for the time being. He may even have on hand a considerable inventory of supplies, and, if he has a manufacturing enterprise, of raw materials, which he does not have to pay for immediately on due date.

The business in his hands is now in effect his individual business, though not, to be sure, for his personal profit. He contracts in

his own name as receiver. Yet, under our practice, apparently he need not expressly contract for limitation of liability. His function as agent of the court differs from that of a trustee, executor, or administrator.

RECEIVER'S CERTIFICATES

Besides the fact that the receiver has assets in his hands relieved from the pressure of maturing claims against the corporation, the court, whose agent he is, can endow him with a credit that the corporation had parted with by creating mortgage or other liens on the property. He can come into court with a petition for authority to create a short term funded debt; and, in the case of a railroad or other public utility affected with a public interest that it shall operate without interruption, on a proper showing that he cannot get credit unless he can give security, can apply for authority to secure the debt on the assets in his hands. It may possibly be that the equities above the existing liens afford enough security for him to get credit, though the corporation could not get it because of the large amount of its unsecured general creditor liabilities. It is likely, however, that this security will not be enough. Under these circumstances the court, in the railroad and utility situations, has the power to create liens superior to those existing under creation by the corporation.

Here indeed equity does something more in changing legal rights than merely postponing the contractual time for their performance. Equity's answer would be that the public interest in the continued operation of a utility is paramount, and the creditor knew he was extending credit to a utility. Equity might conceivably have extended the principle of priority further by arguing that though it was destroying part of the total right, in so doing it was increasing the value of what was left, at least enough to compensate for what it had destroyed. Since the value of any plant lies in its capacity to produce, values would be lost if it ceased operating. Even though operation is not in itself substantially profitable, an idle plant depreciates more rapidly than one in use.

If the mortgage bondholders could immediately assert their legal rights and foreclose, and if, in the foreclosure, they found themselves in the usual position of mortgagees of having to buy the property for themselves, they would find themselves in the same

position as the receiver, namely, in the possession of a property which must have some money spent on it. Since the holders of defaulted bonds are usually most reluctant to assess themselves to provide cash, they would have to do just what the court proposes to do in the case of a utility: put a lien on the property superior to their rights against it in order to procure the necessary funds.

There is this difference. If the bondholders got into the position of ownership, they would have the speculative chance that their value might become greater than the face amount of their claims as bondholders; and this chance they are not getting. They will have ahead of them the lien created by the receiver without immediately acquiring the speculative chance. But if, as a result of the equity proceedings, the bondholders receive full satisfaction, they can have no complaint; and if they are not fully satisfied they will eventually have the opportunity to acquire ownership in foreclosure. Though this analysis is not complete, as later consideration of the reorganization process will disclose, it will serve for the present for the essentials of an argument which might be made in addition to that of the paramountcy of the public interest.

Further, along the line of additional argument, the corporate estate is in equity for the very purpose of having it where the rights of all may be considered in relation to each other. To foreclose on the mortgaged assets, before some plan can be worked out to preserve going concern values, might be disruptive of the enterprise as a whole in which the rights of all are involved. Creation of the receivership lien priority, though destroying something of rights, causes no immediate damage and increases the speculative possibility of the claims affected being paid in full.

If they are not paid or otherwise satisfied, the bondholder will still have the opportunity to take over the property in foreclosure and so acquire the speculative chances of ownership. Assets of the estate increase by an equivalence of the amount of the claim secured by the lien given by the receiver. But it is true that the bondholders are subjected to the hazards of the junior position. Still the application of the receiver for the benefit of a prior lien must be on notice to them. So they have their opportunity to come into court and present their argument against its imposition.

Formal aspects of receiver's certificates are very simple. They

state the receiver's promise in his official capacity (and so, by virtue of his function, limited to funds of the estate in his hands) and refer to the authorizing order of the court, and the lien, if any, imposed by the order.

TAKING POSSESSION

Since the court has assumed the administration of the fund and the present continuance of the enterprise, the first duty of its agent, the receiver, is to reduce the estate to possession. A corporate estate may, and usually does, present a wide variety of assets. It does not matter that liens encumber some. The corporation has an equity in the encumbered assets until the lien is foreclosed. We have seen the receiver authorized, under his ancillary appointment, to go outside the original jurisdiction to take over assets. As far as tangible things are concerned, possession involves physical control and ouster of any who oppose it. For intangibles, as accounts and other receivables, the court order vests the receiver with authority to sue, if necessary, to collect. If the receiver deems an asset not valuable to the estate, he need not take it, but may leave it to its fate in the hands of the corporation.

ADOPTING LEASES AND CONTRACTS

One type of property presents special problems — leases and contracts. We will first consider the lease. It presents aspects of both asset and liability. The right to occupy the leased premises shows the asset side. The correlative obligation to pay rent shows the liability side.

A receiver has the election either to adopt the lease or to disaffirm it. If he adopts, he must pay the rent due to the date of adoption, and continue to pay future rent. The fact that he takes possession of the premises does not in itself amount to an adoption. That he must expressly signify. He is not obliged to disaffirm immediately. On a disaffirmance after use, he must pay, not the stipulated rent, but the fair value of the use. A lessor, dissatisfied with the time the receiver takes for consideration, and believing it unreasonable, may petition the court for an order putting him to his election.

In the event of a disaffirmance, the lessor had no provable claim on account of the covenanted rent as such accruing after

the appointment of the receiver, but only for the reasonable value of the use he has made of the premises up to the time he abandoned them. An interpretation of the law of long standing regarded rent, for purposes of liquidation of an estate, decedent or other, in what is now essentially the economist's use of the word, as something growing out of the soil, the annual crop, which the lessor continued to get fully after the premises were returned to him. So, in that view, the lessor was not damaged.

Such a concept disregarded the obvious fact that the rent in this sense has been commuted to a money payment, and become contractual like any agreement. Though even equity courts held to this antiquated view of the rent covenant itself, they apparently felt the unfairness of it; for if they could find correlative agreements in the lease, breach of which could give rise to damages, they allowed such claims to be proved against the corporate estate in the hands of the court.

We have used the past tense in this connection, not because the principle set forth no longer applies in the settlement of corporate estates under bills of equity, but because presumably, in practice, future settlements will take place under the provisions of the bankruptcy law; and recent amendments provide specifically for proving rent claims. We repeat that this discussion of bills in equity is presented because, first, they have been the principal means by which corporate estates have been settled, and, second, the general plan of procedure for settlement under the new provisions of the Federal Bankruptcy Act will probably continue essentially the same.

Amendment of June 18, 1934, added Subdivision 7 to Section 63a (Title 11 U. S. Code Ann., Section 103a) and enumerates among provable debts "claims for damages respecting executory contracts, including future rents whether the bankrupt be an individual or a corporation, but the claim of the landlord for injury resulting from the rejection by the trustee of an unexpired lease of real estate or for damages or indemnity under a covenant contained in such lease shall in no event be allowed in an amount exceeding the rent reserved by the lease, without acceleration, for the year next succeeding the date of the surrender of the premises plus an amount equal to the unpaid rent accrued up to said date: Provided that the court shall scrutinize the circumstances of an assignment of future rent claims and the amount of the consideration paid for such assignment in determining the

amount of damages allowed the assignee hereunder." (This last apparently indicates the recurrent bugaboo the speculator in claims presents to the legislator.)

A claim for damages may arise on an election not to adopt a contract. With this exception, the general principles just set forth of the relationship of a receiver to leases apply. We need constantly to keep in mind the difference between claims against the corporation and claims against the receiver. Both are a charge against the fund. In the settlement any unpaid liability of the receiver becomes a claim with a preference. It is subject, however, to all liens unless the court order authorizing the debt expressly gave it a superior position.

ASCERTAINING THE CORPORATE LIABILITIES

We now turn to another aspect of the court's administration of the fund. We have seen the receiver taking possession of the assets and continuing the enterprise. Though many and complicated legal questions arising out of his function confront him, he is essentially an executive charged with carrying on. Since, however, the court has taken the fund in charge to preserve it for the benefit of all who have an interest, it becomes important to ascertain who does have an interest, the nature of the interest, and its extent. If the situation is fortunate enough, it may be that creditors' claims will be satisfied and the property turned back to the corporation. The corporate shell from which the receiver has extracted the meat of assets still exists, available to fulfil its function of container.

FUNCTION OF THE MASTER

For the purpose of ascertaining who have an interest, and the nature and extent of the interest, the court appoints a master. It may make the appointment as part of the original decree, granting the petition of the creditor's bill and appointing the receiver; or, shortly after it, it may make an additional order appointing the master. His function is judicial as contrasted with the executive function of the receiver. The order appointing him directs the receiver to give notice of the appointment by publication, and by mail, to all creditors of the corporation whose addresses he has, of the time within which, as sixty days, the

order requires the claims to be presented, with proof thereof, to the master.

Further, the order bars from participation in the assets all who do not present their claims within the designated time. Proof made on the presentation of the claim is only prima facie — the affidavit of the claimant, and, if he has a written instrument for evidence, its production for examination. If the master does not allow the claim on this evidence, he notifies the claimant, who then has an opportunity for a hearing and the offering of further evidence. Any creditor may object to the allowance of a claim. In short, we have a judicial proceeding, with the master acting as judge, and an appeal from his findings allowed to the court.

An unsecured debt which by its terms is now due does not present much difficulty. Neither does a secured debt which will certainly become due in an amount already ascertained. The receivership accelerates their maturity, i.e., the operation of the law causes them to fall due, just as in the case of an individual debtor who dies leaving an estate to be settled.

SECURED CLAIMS

A secured claim presents more of a problem. The creditor has in his security that which may be ample to provide his payment in full. With respect to that part of the fund available for unsecured creditors, he has a right to share in it to the extent that his security does not satisfy the debt. But at the time of notification to present his claim he still has his security; its value is not liquidated, and he does not know how far it will go in satisfaction of the right he has. Yet he must present his claim within the specific time limit of the notice, and must complete his proof within the time limitations of the receivership. In what amount may he prove?

Our Federal courts have a rule in equity proceedings different from that imposed on them in bankruptcy by the statute. Under our creditor's bill the secured claimant proves for the full amount of the debt. If, when he liquidates his security, the proceeds are more than enough to satisfy his debt in full he must turn the surplus back to the fund.

Let us consider a concrete example, and assume as the facts that the fund in liquidation has only one secured claim against it, which is for a debt of $1000; that the unsecured debts amount

creditor may obtain from the general creditors' fund, the liquidation value of the security he holds may be ascertained by sale, agreement, arbitration, compromise, or litigation, as the court may direct. That is, if circumstances do not permit turning the asset into cash, whether because it is necessary for use in the enterprise to preserve the going concern as a whole, or for any other reason, its value for purposes of settling claims may be found in some way other than by sale.

Sometimes a corporation has authorized and unissued mortgage bonds which would be available for financing except that the management believes that the price obtainable at the time is disadvantageous either because of the condition of the enterprise or the condition of the market. They hope in the one case that affairs of the enterprise will become more prosperous, or, in the other case, that general financial conditions will improve, and that later they may dispose of their long term securities on more favorable terms than they can obtain at the time. So the management may issue and pledge such long term bonds for a smaller face amount of short term notes, hoping that before the notes fall due conditions for selling the bonds will improve. If the corporation goes into a receivership before the notes so secured are paid, a liquidation problem arises. On the principles governing any secured claim, the creditor of course can recover in total not more than the face amount of the notes. If he liquidates the collateral by selling it, he applies the proceeds on his debt to its satisfaction *pro tanto*.

But the collateral which the purchaser at the pledgee's sale has bought is itself a debt of the corporation on which the holder has a claim for its face amount. The amount he may in due course receive on this claim, added to the amount the note holder may realize in total, may be greater than the face of the notes, which represented the indebtedness of the corporation at the time it went into receivership. In effect the corporation has retroactively become additionally indebted. The purchaser of the bonds has a right as a claim to the full amount of the bonds. The only way the court could prevent this situation from arising would be to enjoin the note holder from selling his collateral. The power of the court to enjoin, however, seems not settled.[1] The problem has been dwelt on at some length as illustrative of the difficulties which liquidation presents.

[1] See Glenn on Liquidation, Sec. 531, p. 762.

CONTINGENT LIABILITIES

Contingent liabilities of the debtor raise further questions. A contingent liability may give rise to a provable claim as well as a liability that does not depend on a contingency. The debtor whose estate is being settled may be an endorser on a note, may be surety or guarantor. Such situations create rights in the debtor's estate, and these rights will be evaluated, if possible, and, if they have an ascertainable value, will be allowed as claims. If the value of the right is not capable of being computed, however, because the liability has only a slight or remote chance of becoming absolute through failure of the primary liability, then a claim on the contingency will not be allowed.[1]

TORT CLAIMS

Claims in tort, i.e., not arising out of contract liability, but for breach of some duty which the law imposes, present a whole field of inquiry in themselves. No difficulty arises if they have been reduced to judgment. It effects a metamorphosis of the claim into a debt. The judgment debt so arising is like any other judgment debt.

We are not concerned with the consequences of tort claims against individuals, and in connection with decedents' estates, but only in relation to corporation receiverships and bankruptcies. Equity preserves such claims, and in its decree provides for their liquidation on application for leave to sue the receiver, or by filing claims with the master, who will hold a hearing on them and report his findings to the court within the time set by the order referring them to him. Under the Bankruptcy Act, tort claims not reduced to judgment could not be proved at all, until recently the amendment provided for their provability in reorganization proceedings under the act, and so correlated in this respect such proceedings in bankruptcy with settlements under bills of equity.

[1] *Equitable Trust Co. of New York v. Western Pacific*, 244 Fed. 485, affirmed — with modifications — in *Equitable Trust Co. v. Denver & Rio Grande R. Co.*, 250 Fed. 327, certiorari denied, 246 U. S. 672, presents an important case of the determination of a large contingent liability of a guarantor which was liquidated, i.e., the amount of the liability determined, by the upset price in foreclosure of the mortgage of the obligor primarily liable.

EXPENSES OF RECEIVERSHIP

We will next consider the expenses of the receivership in relation to the corporate fund. We might take the matter up as part of the discussion of preferred claims, which we will consider later. But the idea of preferred claims is limited to those which arose against the corporation before the receivership. Moreover, we might do well to keep the idea of a preference limited to rights in the general creditors' fund, and as having nothing to do with that part of the total corporate fund subject to liens, except as the secured creditor may be satisfied and a surplus left to benefit those who have no security.

However, if the receivership incurs expense in preserving the value of a lien, that expense may be chargeable against the security, that is, take precedence over the lien. Though it may not be easy to determine in some specific cases whether the expense was incurred to preserve values for a lienor or to preserve values for those junior to him, it is the purpose that affords the test.

Of course the receivership expenses will be paid and the whole fund used to pay them, if necessary. The considerations just presented have a bearing only on the extent to which they should affect the distributive share of each claimant against the fund.

MATERIALMEN AND SIMILAR CLAIMS IN THE CASE OF RAILROADS

Since materialmen and similar claims in the case of railroads may affect the rights of lienors, as well as create a preference in the general creditors' fund, we will consider this matter before going on to a further consideration of priorities. We see here another effect of the principle of public policy that railroads must be kept running. And here again, not only the public interest, but the interest of all, including mortgage bondholders, requires that a road capable of averaging to earn more than the bare cost of operation should not stop carrying on its business. However, it requires the principle of public policy to cause incidental consequences in these private interests.

If a road is to run, it must be in a physical condition to carry traffic.

For the purpose of considering priorities, whether as against liens or in the general creditors' fund, we must distinguish at the

outset between supplies furnished for betterments and those furnished for maintenance. Payment for materials used in extensions and betterments constitutes a capital cost, but payment for material used in maintenance constitutes an operation expense.

A materialman who furnishes supplies for betterments is a creditor like any other. What he has done has not been necessary to keep the road running. But one who has furnished supplies for maintenance has done something essential to the continued functioning of a common carrier, and has preserved the going concern value for the security holders.

We have seen how, almost certainly, the management of an enterprise, by failure to maintain the property, squeezes dollars out of it to pay debts falling due, including interest. So, in most instances, the bondholders have received something which, except for the distress situation, would have been paid for preserving the value of the property. Though they have a lien on the asset, it is not their sole property; junior claimants have an equity in it, and the value of their equity ought to be preserved until in foreclosure it is liquidated or cut off.

If the interest has been paid at the expense of maintenance, the bondholders have received something to which they are not equitably entitled. At least such is the essence of the discussion of the courts in this connection. They do not consider that the junior claimants may have received value in having preserved to them, at the time of the interest payment, the speculative chance that foreclosure might be avoided, and the enterprise carried on to the full satisfaction of all creditor claims, and the preservation of the stockholder ownership. Looking at the fact of payment, not from the viewpoint of the time at which it was made, but from the viewpoint of a later date, they see the effect on the equities that subsequent events have given it. Maybe the answer is that business men ought not to speculate except for the assumption of risks necessarily arising out of the nature of the enterprise, and here the risk they took was not a necessary economic hazard.

If it is found that there has been such a diversion of income, then those who have furnished the materials for a period of time before the receivership have a right to reimbursement out of the mortgaged assets to the extent of the amount diverted. Though there is no rule of law limiting the period, courts have developed a practice of making it six months before the receivership, so that the principle is often called the six months rule. Three ideas

might be invoked to sustain a limitation: that the creditor has not been diligent in pressing his claim; that, since the road kept running for such a period after the supplies were furnished, presumably they were not essential to keep the property going; that expediency requires placing some limit on the inquiry into diversion.

If the debt is for something necessary to carry on the business, the creditor is entitled to a preference in payment out of the corporate fund; but this preference extends to the mortgaged asset only under the conditions just indicated.

Regardless of the matter of diversion just discussed, the current creditor has a preference out of income of the receiver. In the case of a railroad the enterprise is considered a continuity whether in the hands of the corporation or in the hands of the court. So, since the operating expenses of the receiver must be paid before any of his earnings are turned over for the general fund, the result is that such current creditors of the corporation secure a preference as against other unsecured creditors.

PRIORITIES

We are not now dealing with anything affecting the priorities of liens, but with claims having priorities in that part of the total fund available for general creditors. Before that can be ascertained, tax liens, statutory liens of mechanics and materialmen, contract liens of mortgagees and others, all hold their special claims against specific property. Among claims against the general creditors' fund, however, public policy creates certain priorities.

Wages. Ever solicitous of the wage-earner, the law gives him a preference subject only to the expenses of administration.

Taxes. Taxes which have become liens, either through the operation of the law, or as a result of proceedings by the collector, take their place among liens and are not a subject for consideration with priorities in the general creditors' fund. Such taxes as accrue while the corporate fund is in the hands of the court, the receiver should pay as an expense of the receivership. But there may be taxes due which do not have liens when the court takes over the enterprise. These obtain a priority. The paramount interest of government gives tax claims the right of way. Here the Federal Government takes precedence over the

States. But there may be debts to government arising out of contract.

Debts Due the United States. Act of Congress [1] gives debts due the United States the next priority.

Priorities Resulting from State Statutes. If the statute of a State provides for a priority on various items, it is given effect.

RECLAMATION

It may be that the receiver, on taking possession of the estate, finds in it property belonging to others, but in which the corporation has an interest. Then the equities of the parties must be ascertained and adjusted.

This statement will become clearer on considering a situation, in the field of dealing in securities, which arises on the liquidation of a stockbrokerage concern. Since stockbrokers commonly engage in business as individuals or partnerships, the matter is not corporate; but it is representative of any equities in liquidation arising out of pledge.

In a margin account, the broker makes a loan to his customer and holds the purchased stock as collateral. The customer owes a debt and has a property interest in the shares. Since the debt the customer owes is an asset of the estate, he must satisfy it in full. He may reclaim the shares themselves on payment of the debt, but to do so he must be able to identify his shares. If he cannot identify specific shares as belonging to him, he must still pay his debt, and has only a claim for the value of the shares, on which he will receive his liquidation dividend at whatever number of cents on the dollar it may turn out to be. For this purpose the certificates do not have to be in the customer's name. The broker may hold them in the form in which he received them, or especially in anticipation of a dividend, he may have transferred them into his own name. Still, the shares are, in equity, the customer's. If the broker held shares not specifically identifiable by customers, but of a kind bought by them, they may reclaim pro rata.

Under the customer's consent or waiver of various rights of a pledgee, which a broker customarily requires as a condition of opening the account, the broker may, and customarily does, mingle the shares of customers as collateral for a loan to him by

[1] 31 U. S. Code Annotated, Sec. 191.

a bank. If a broker has in this way commingled shares and repledged them, the bank will liquidate the collateral, apply first towards satisfaction of the debt the proceeds of shares of unidentified ownership, and then a pro rata of the proceeds of identified shares; after that their owners are entitled to their balances.

Reclamation may be available in matters other than the pledge of collateral. The liquidating corporation may have entered into a contract to convey real estate. Since the purchaser in a real property contract has a right to specific performance, he has an equitable property in the land. If the receiver adopts the contract, we have no problem of claims. The land is conveyed and the buyer pays. If the receiver disaffirms the contract, however, the value of the land to the buyer may be much greater than the value of his claim for breach. This would especially be the case of a buyer who has paid a substantial amount of the purchase price. The buyer may prefer to enforce his equitable claim and get the land. It may be that, under the terms of a contract not for land, the corporation, nevertheless, possesses something in which the other party has a property. On disaffirmance of the contract the property may be reclaimed.

SET-OFF

On a current account, in which the liquidating corporation is both debtor and creditor, the other party to the account can offset the amount due him against the amount he owes the corporation, so that he is obliged, or left to his claim, as the case may be, only on the balance. Since the receivership of the creditor's bill in equity accelerates the maturity of the corporate debts, most jurisdictions permit the set-off against a debt of the corporation not yet by its terms matured. This holds in the Federal Courts.[1]

Our sketch of the process of determining the relationship to each other of those who have rights in the corporate estate in liquidation has been presented simply to indicate the problem of arriving at a settlement. The problem and the process are essentially the same whether the settlement takes place under a creditor's bill or in bankruptcy. Though our viewpoint has been that of a bill in equity, we have not attempted to look closely enough at what we are sketching to distinguish differences between

[1] New York and Massachusetts contra. Glenn on Liquidation, Sec. 546, p. 788.

equity and bankruptcy as processes of settlement. The sketch is not a blueprint for lawyers, but a freehand drawing for laymen; and for them, only to present an idea.

Even as a picture for laymen it is blurred in the attempt to show the process as applicable to railroads, other public utilities, and industrial enterprises alike. The outline would be clearer if one picture were drawn for railroads and another for industrials. Still, if the two sketches were superimposed, many of the lines would coincide. It is hoped that an attempt at the composite for the sake of brevity has resulted in a picture, nevertheless.

It is apparent that two absolutely opposed ideas are operative throughout: one, that we have a collection of assets which are to be turned into cash, and a collection of liabilities which are to be settled in cash as far as the cash will go; the other that we are to keep intact and together those assets necessary for operation, and to go on doing business. Relationship of rights is ascertained "as though" the liquidation were to be in terms of cash, except as the idea of continuing the business effects modifications. There must be a measure of the amounts of the values involved in the rights, and money is the measure. We shall see in following chapters how the conflicting ideas work out to a settlement.

CHAPTER XLI

Group Action in Protecting Rights

We have seen the corporation by a collusive bill in equity placing the corporate fund in the hands of the court, for the protection of creditors as a whole, to preserve going concern values against the race of diligence of creditors, each of whom is acting for himself. And we have indicated that in the future this protection presumably will be sought through the process made available by the amendments to the Bankruptcy Act instead of the process of the collusive bill.

Further, we have seen the receiver, appointed by the court, taking possession of the property; examining the assets; considering the lease and contract engagements of the corporation, to decide whether it would be more profitable to adopt or to reject them, in view of all the consequences of either course. We have seen that more often than not he finds the property in a run-down condition, but that he has credit, and possibilities of credit, greater than the corporation had immediately before the receivership, by which he may provide funds for maintenance.

Also we have seen the appointment of a master to take proof of claims, so that the individual rights may be ascertained, sorted into classes, and their relative rights determined as affected by the probability that not all can be satisfied in full.

DIFFICULTY OF INDIVIDUAL ACTION

But a man with a thousand dollar bond, a creditor to the extent of a few hundred dollars, a stockholder owning only a few shares, cannot afford the cost, in time or money outlay, of complete vigilance in asserting his rights and ascertaining his proper relationship to all others interested in the corporate fund. He is, however, one of a large number of people with interests identically corresponding in kind, though differing in amount.

He falls into a class. If all in the same class can find some mechanism through which they can act as a group, that is, effect a resolution of their individual wills into a force exerted as though that of a single will, they reduce the cost to each; and their united action increases the effective power they can bring to bear. Correlatively, if the court can deal with them in groups it saves much time. One attorney argues for all who form the group, instead of a number of attorneys representing those who have interests of large enough amount to justify the expense of individual action.

TRUSTEE REPRESENTATION ALONE NOT ADEQUATE FOR BONDHOLDERS

Holders of mortgage bonds and collateral bonds, to be sure, already have a device for representation in the trustee under the indenture. We have seen, however, that the trust company, in consenting to serve as trustee, delimits its responsibility, and insists on conditions which must be fulfilled before it will act in asserting the rights of the bondholders. It will proceed only on receiving security to indemnify it against liabilities it may incur in acting. It will proceed only if a certain percentage of all bondholders demand that it act. Perhaps, under the terms of the indenture, it is not authorized to act, unless a stated percentage require it to do so. Moreover, its duty may be to assert the full rights of the bondholders, not those rights as diminished by conflicting equities of other classes of claimants, or diminished by agreement of some of the members of the class. Although the bondholders have the trustee mechanism for group action, they must find another mechanism to start the trustee going.

MANAGEMENT AND INVESTMENT BANKERS

It must be kept in mind that the management, including in this term the investment bankers who have participated in financing the enterprise, took the initiative in causing the receivership. One may have no doubt that a desire to keep the initiative throughout the settlement of the corporate affairs motivated them, as well as a desire to do what ought to be done for the protection of those interested in the corporate fund. Though such initiative may result in personal benefit to the management and the investment bankers, it may be, and in most instances

probably is, to the benefit of those having rights in the enterprise. They need to be vigilant, however, to see that disadvantage to them does not result from an unjustified benefit to the management and the bankers.

The value of this organizing initiative to the investor appears by comparison of the usual railroad and industrial corporate reorganization with what happened in the real estate mortgage participation certificate situation in New York City on the defaults resulting from the decline in business at the end of 1929. Large apartment houses and office buildings had been financed by the distribution to investors of issues of securities similar to mortgage bonds. This is not the place to enter into a description of the technique of issuance. An individual holder of an entire mortgage can exercise his own judgment, act for himself, and foreclose or take other protective steps as he sees fit.

But holders of these issues of real estate mortgage securities found themselves with the problem of group action for which they had no solution. The mortgage companies, which, in distributing the issues, occupied the relative position of investment bankers, were in distress themselves. Even if they had not been, still they had no experience of the kind required at the juncture of default. There was no one to step in promptly and take the initiative for the benefit of security holders. The chaos which resulted makes the usual course of railroad and industrial corporate reorganization, with all its many flaws, appear like a comfortable highway for security holders.

VOLUNTEER COMMITTEES

A reader of the financial pages of the newspaper may see in the evening paper the news of a default in the payment of interest falling due that day on an issue of bonds, and of the appointment of a receiver. People who are not lawyers seldom think of the processes involved in these matters. A thought may float through the reader's mind that some quick work must have been done. It may have been. But not as swift as defaulting at 9 A.M., then preparing a bill in equity, presenting it and getting a decree, all in the same day. Very likely the bill has been drafted by counsel and lain in the files for six months or a year awaiting the course of affairs. Finally events indicated clearly that the corporation could no longer carry on.

So bankers, management, and counsel prepare for the stroke of the guillotine which severs the head of management from the body of assets. They believe that the consequences of the stroke will be less painful if they release the knife themselves. They take the initiative in the receivership partly to gain the initiative in the reorganization, which they do by setting up themselves the mechanism for group action by various classes of those interested in the corporate fund. They select the members of committees which will offer to act for each of the classes.

On the day after the news of the receivership the advertising columns of the financial pages of the morning papers present the appearance of having broken out in a protective committee rash. Brown and Jones and Robinson present themselves as a protective committee for the bondholders of the defaulting issue. Smith and Johnson and Williams say they are prepared to serve the general creditors. Roe and Doe and Jackson announce themselves as a protective committee for stockholders. And so on for the half dozen, more or less, classes of interests, including, it may be, issues of securities senior to the one in default. The number of members of each committee may run from three to seven. With each list of committee members appears the name of its counsel and secretary.

COMPOSITION OF THE COMMITTEES

Such committees are sheer volunteers. They are people inviting the bondholders, the general creditors, or the stockholders, as the case may be, to appoint the committee as agent with a wide authority to represent its principals in various matters looking toward a settlement of the corporate affairs, and so providing a means for group action. We might, with as much propriety, advertise ourselves as a committee for the purpose. But the investment bankers, who (without making public announcement) are likewise volunteering to act as engineers of the settlement, have placed on each committee at least some generally known names, intended to win the confidence of security holders. And the name of some well known firm of lawyers appears as counsel to the committee. The running start of the committee in announcing itself immediately after the appearance of news of the receivership, the prestige of its names, the well known fact that it is the "official slate," in the sense of being the nominee of the manage-

ment and bankers who are taking the initiative in the settlement of affairs, give this committee an advantage over another that might later volunteer.

DEPOSITARY

Each of the advertisements announcing a committee states that a deposit agreement has been prepared, and gives the name of the trust company designated as depositary. The announcement invites the security holders to deposit their securities with the trust company under the terms of the agreement.

DEPOSIT AGREEMENT

The deposit agreement, signed by the trust company and the members of the committee, states that a security holder may become a party to the agreement by depositing his securities thereunder and accepting a certificate of deposit therefor. The agreement is in printed form, and copies may be obtained from the depositary. Terms of these agreements vary, but they have a similarity. All are for the accomplishment of the same results. Ordinarily they:

Provide that the deposit shall vest the committee with the title to the security deposited;

Authorize the committee to take any action it deems proper to protect the rights and interests of depositors;

Permit the committee to borrow money and pledge the deposited securities;

Authorize the committee to adopt a plan of reorganization, but with opportunity given to those who do not assent to the plan to withdraw their securities from deposit;

Authorize the committee to employ counsel and other assistance;

Authorize the committee to charge expenses against the deposited securities, or, in the event of the failure to arrive at a plan or reorganization, or of a formulated plan to go through, or in the event that the depositor does not assent to the plan, to charge him with his pro rata of the expenses in cash. And often, to encourage security holders to deposit, the agreement provides that expenses shall not exceed a certain per cent — say, two per cent — of the face amount of the securities.

CERTIFICATES OF DEPOSIT

Certificates representing a deposit under the agreement are simple instruments. One might run substantially as follows:

Certificate of Deposit Six Per Cent First and Refunding Mortgage Bonds of Rockville, Westminster and Eastern Railway Company. Due August 1, 1956.

Under deposit agreement dated May 15, 1935, between John Brown, Henry Smith, Richard Dixon, James Thompson and Robert Williams, Committee, and holders of Six Per Cent First and Refunding Mortgage Bonds of Rockville, Westminster and Eastern Railway Company, due August 1, 1956.

The Security Trust Company of New York City hereby certifies that it has received from William Adams five thousand dollars in face amount on the above named bonds, subject to the terms and conditions stated in the deposit agreement indicated above. The holder assents to and is bound by the provisions of said agreement by receiving this certificate, and is entitled to receive all the securities, benefits and advantages to which the depositor of said bonds is or may become entitled, pursuant to the provisions of said agreement. The interest represented by this certificate is assignable, subject to the terms and conditions of said agreement, by transfer on the books kept by this company for that purpose by the holder hereof in person or by attorney upon the surrender of this certificate duly endorsed for transfer.

New York City, June 3, 1935

Security Trust Company of New York
by Thomas Ames
Vice President
Peter Mason
Assistant Treasurer

Registered June 3, 1935
Federal Trust Company of New York
by Everett Wilson
Assistant Secretary

If the bonds are listed on the stock exchange these certificates of deposit will also be listed. Since the bonds are in default they, and the certificates, will be dealt in flat, that is, without the accrued interest; so the quotation on them represents the entire price to be paid.

SHOULD THE SECURITY HOLDER DEPOSIT?

Security holders who are not familiar with the reorganization process often ask whether or not they should deposit.

It is desirable that the corporate affairs should be settled and the enterprise set on its way free from receivership as soon as possible. This consideration would lead to a prompt depositing so as to form an organized group, as large as may be, able to act through its committee representative. The influence of the committee increases with the increase in the amount of securities it speaks for.

On the other hand, if the security holder deposits, and no reorganization takes place, he will have to bear his share of the expenses of the committee, and would save just that amount by not depositing. Often the market price of the certificates of deposit falls below that of the undeposited bonds. Such a price difference represents a market opinion that those who are seeking a reorganization will not be able to carry one through.

RIVAL COMMITTEES

If the security holder mistrusts the purpose of those who are taking the initiative, he will not deposit, but will hope that their plans will fail, and that a new attempt will be made, either under new direction, or by the same people in a chastened spirit. Opposition may arise, and rival committees offer themselves. One may wish to remain free to join others in depositing with such a committee. As we have seen, protective committees are only volunteers. Anyone is free to come forward to organize groups of security holders. Sometimes opposition to the plans of the initiating bankers and management does arise, and becomes strong enough to effect essential modifications in the plan for settlement first presented.

WORK OF PROTECTIVE COMMITTEES

Now that we have mechanism for group action set up, let us see just what work must be performed through it. There are two aspects of the work to be done: first, to establish the nature and extent of the legal interest in the fund held by the class which a committee represents; second, to bargain with other classes for relative terms in the settlement of their rights, as affected by the

equities arising out of the principle of preserving the going concern. Presumably the first task will not require much of the effort of the committee. Usually there is little doubt of the legal rights of the holders of various issues of bonds and stocks. If there is a question about any of the general creditor claims, presumably the committee for this class will leave the individual claimant to satisfy the master of the justice of the claim. It is the bargaining that will require the attention of the committee.

ANALOGY TO A "COMPOSITION"

In the settlement of relatively small individual businesses which run into difficulties, creditors are familiar with endeavors of debtors to settle by means of a voluntary composition. A debtor arrives at such a settlement by bargaining with his creditors. They agree to accept such terms as will enable the debtor to go on with his affairs. They may accept less than the amount due them, may extend the time of payment, may modify their legal rights in any way they see fit. The debtor bails himself out of his harassing situation to a conditional freedom, which becomes permanent on his performing his new promises.

No creditor can be forced to take less than his legal right; but it may be good business for a creditor, by doing so, to enable the debtor to continue his enterprise and keep on being a customer of the creditor. To this end, large creditors may be willing that the debtor should pay in full a few who refuse to come into the composition, and especially to pay small debts. Some creditors, knowing the desire of the debtor to continue his business, and the willingness of other creditors to enter into a composition, may take advantage of the situation to bargain for preferential treatment.

In bankruptcy proceedings a debtor may offer a composition to his creditors; under certain conditions, if a majority, both in number and amount, assent to it, the court will confirm it; on confirmation the non-assenting creditors scheduled will have to accept the terms agreed to by those assenting. Such a settlement, however, contemplates payment in cash, immediate or deferred. We shall comment on this provision for composition in bankruptcy in another connection.

We are taking a glance at this matter of compositions here merely because it presents a process of bargaining to enable the debtor to continue in business, and affords so much of analogy to

the work of the protective committees we are interested in at this point. They are likewise bargaining for a settlement, or reorganization, that will enable the corporate enterprise to continue.

PROBLEMS INVOLVED

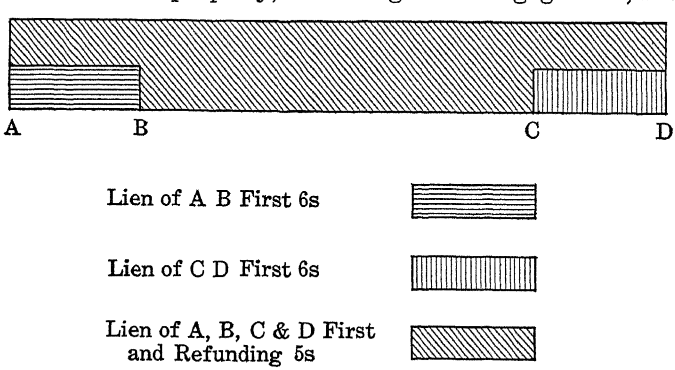
Let us set up a hypothetical situation to illustrate as simply as possible something of the problems of railroad reorganization.

The A, B, C & D Company shows on the liability side of its balance sheet the following:

Capital stock		$25,000,000
Accounts (representing preferred claims for materials furnished under the six months rule, etc.) and wages payable		2,500,000
Miscellaneous accounts payable		500,000
Interest matured		1,050,000
Taxes		1,000,000
Funded debt:		
A B First 6s	$10,000,000	
C D First 6s	10,000,000	
A, B, C & D First and Refunding 5s	30,000,000	
Ten-year unsecured notes, 6s	5,000,000	
Equipment 5s	5,000,000	
		60,000,000

In its present form the enterprise shows the result of a consolidation of three corporate enterprises. Two had a mortgage debt before the consolidation. One had a floating debt which was paid off. The merger was financed principally through the proceeds of the A, B, C & D First and Refunding 5s, and through the exchange of stock.

A sketch of the property, indicating the mortgage liens, shows:



Since the A B division holds the A terminal situation, interest has so far been paid on the A B First 6s.

The C D First 6s and A, B, C & D First and Refunding 5s are in default.

The receiver has adopted the Equipment Trust agreement. So the Equipment 5s are not in default.

It is desirable to hold the entire property together. From the viewpoint of the holders of the A, B, C & D First and Refunding 5s it is essential to retain the A B division, but possible to make C the other terminal of the line. They strongly desire, however, to retain the benefits of the line unified through to D. Holders of the C D First 6s are aware of the value of their division in completing a system. It could be operated independently. But these divisional bondholders do not want the problem of undertaking ownership and operation. They have no equipment, and would have to finance the purchase of some; and they would have to provide some working capital for themselves. Holders of the A, B, C & D First and Refunding five per cent bonds are perfectly aware of the difficulties C D First six per cent bondholders face in taking over their division.

A railroad reorganization usually presents, not one, but many such problems — divisional liens, leased lines, ownership of subsidiaries financed through the issuance of collateral bonds, etc., etc. In each case there must be a sacrifice of legal rights in order to share in the benefits of preserving the enterprise in its entirety as an operating unit.

ADVERSITY OF PROTECTIVE COMMITTEE INTERESTS

Each of the protective committees is a device through which the group of one class of interests may assert the importance of its legal claims, and protect itself against encroachment by other classes of claimants. These committees represent adverse interests, and should deal with each other on that basis. Here are at once one of the difficulties and one of the advantages of the "official slate" committees put forward by those, the management and the bankers, who are taking the initiative in the endeavor at reorganization.

Collusiveness in presenting the bill in equity results directly only in that being done which ought to be done — placing the property under the protection of the court. But the very reason

for these protective committees is to provide a means for asserting real adversities of interest. Yet these official slate committees are perhaps all the nominees of the banker-management endeavoring to engineer a reorganization. The situation arouses a suspicion that they might hear a master's voice; and that the master's interest might lie more with one group than with another, or even be opposed to that of all the protective committee groups.

On the other hand, it is to the interest of each group that a reorganization be achieved, and that antagonisms in pressing the claims of the several classes should not prevent the end, important to all, from being attained. It is desirable that the committees should be so composed as to be capable of arriving at harmony. Presumably the banker nomination is helpful in this respect; and that is all right, if it is not too helpful. The committee should keep themselves free from any influence other than their duty to achieve the best possible results for the group they represent.

REORGANIZATION COMMITTEE

For the purpose of bringing the adverse interests to a reconciliation, a reorganization committee is formed. It may be that one member of each of the protective committees will also be a member of the reorganization committee. Probably this does no harm. The plan must meet the approval of each of the protective committees as a whole. The reorganization committee will endeavor to agree upon a plan and to procure the approval of the several protective committees.

FUNCTION OF THE BANKERS

Since counsel for the initiating banker-management will draft a plan for presentation to the reorganization committee, this may be an appropriate place to begin commenting on the function of the bankers in the reorganization process.

Someone will have to provide some cash to effect a settlement of the corporate affairs. This matter of cash requirements touches the core of the reorganization problem. Mostly, the old claims will be settled by the acceptance of new claims. We have seen, however, in the case of a "composition" by an individual business man in financial distress, some creditors demanding present cash; so, in settling the corporate affairs, some claims will have

to be disposed of by immediate cash payment. In the individual composition the creditors who accept new promises consent that the debtor use some of his cash to pay those who do not come into the agreement. But in the corporate situation of the kind we are considering, there is not enough corporate cash for this purpose.

Very likely the bankers distributed at least some of the corporate securities in default, and so may well believe that they have a moral duty to do what they can towards a rehabilitation of the corporate affairs. The bankers are not guarantors, and at this juncture it is probably fortunate for the investor that they are not. If they were, they would be in financial distress along with the corporation, and in no position to be active in its rehabilitation. The possible additional cent or two on the dollar that the guarantee might give the investor would be of less value to him than having someone ready to take a prompt and continuously active concern with the problems of reorganization.

It may be that the possibilities of collusion in the process after the appointment of the receiver are too tempting. With protective committees who are nominees of the bankers; with counsel for the bankers drafting the plan of reorganization; with a receiver appointed in proceedings essentially initiated by the bankers; with counsel to the receiver and counsel to each of the committees conceivably helped to their retainers by the influence of the bankers; with other advantages that may be gained by those taking the initiative; the situation may be seen, and may conceivably even have been planned, as an opportunity for piracy. It is possible that the bankers might have interests to foster outside of, or conflicting with, the immediate one of the most advantageous settlement of the corporate affairs. Protective committees of the official slate and their counsel, all sharing in allowances made by the court for expenses of administration, may tacitly acquiesce in a "scratch my back and I'll scratch yours" attitude, and not oppose the amounts asked by the receiver and his counsel, and by each other, for compensation. Though it is the duty of the court to make only fair allowances, still, if no one protests, the court lacks support in cutting down the amounts requested.

A reorganization under a bill in equity, with non-assenting security holders to settle with, must be underwritten to assure the necessary cash. Future reorganizations under the Bank-

ruptcy Act amendments, which force the non-assenting to accept the settlement that the assenting agree upon, will be relieved from this aspect of cash provision. But preferred claims also require cash. And usually cash must be provided for working capital. So probably reorganization under the Bankruptcy Act will have to be underwritten.

Since the burden of assuring the cash will fall on the investment bankers who are taking the initiative, they must have a plan of reorganization possible for them to underwrite.

CHAPTER XLII

Foreclosure and the Upset Price

THE JUDICIAL SALE

By looking forward to the event which is the pivot on which the reorganization revolves, we shall have a clearer view of the problems and the means of solving them. We are still considering the process as it went on before the recent amendment to the Bankruptcy Act. All plans anticipate the moment of a judicial sale of the property. Such a sale may take place in the foreclosure of a mortgage. It may be a sale in bankruptcy. It might even be an execution sale. We are assuming that it will be a foreclosure sale.

Always anyone can agree to take something other than immediate cash in settlement of a claim; no one, before the recent Bankruptcy Act amendments, could be forced to take anything but cash. Later we will comment on instances in which equity courts forced securities on those who had not agreed to take them. For the moment we will let the statement (that no one can be compelled to take anything but cash) stand as representing what has been more generally believed to be a limitation on the powers of the courts.

Except in the statutory case of a composition in bankruptcy, no one could be forced to take less than a satisfaction of his legal rights of payment in full, otherwise than by a liquidation of the value of his interest through a judicial sale of the assets to which he, and others of his class, had at law a right to resort for payment. The plan of reorganization is simply a voluntary agreement among those who assent to it. Those who do not assent have a right to their pro rata of a cash liquidation. For emphasis, we permit ourselves, here and elsewhere, the tautology of the two words "voluntary" and "agreement." The liquidation must be on the regular conditions imposed to assure fairness — that the sale shall be on notice, advertised, and public, that is, at

some place to which the public has access, so that any and every possible purchaser may appear and offer to buy; in short, at public auction.

ASSENTORS AS BUYING OUT NON-ASSENTORS

In effect those who assent to the plan buy out the interests of those who do not join them. Perhaps a further analogy will be helpful. Let us consider what may happen at a partition action of tenants in common of a parcel of real estate. Assume that A died leaving this real property to his three heirs, B, C, and D. Each has, as we say, an undivided one-third interest in the land. The premises are of such a kind, as a single dwelling house, that they can be sold only in their entirety. A little later D wants to realize cash for his interest, but B and C do not want to sell.

Ordinarily D would have difficulty in finding someone who would buy a third interest. And B and C will not join with him in selling the entire premises to a buyer. But D can bring a partition action, forcing a sale of the property at auction. If B and C want to continue their ownership, they will have to find some way to finance a purchase at the auction sale; then appear there and bid the property in. Suppose at the sale the property is knocked down for $9300, out of which will come the expenses of the sale amounting to $300. A and B will have to pay cash of only $3300, of which the representative of the court will allocate $300 to cover the expenses and will pay $3000 to D. There would be no point in making them pay in cash the full $9300 of their bid, as they would immediately receive $6000 of it back as representing their pro rata of the net purchase price. Since they have to raise only $3300 in cash, obviously they have an advantage in the bidding over anyone else, because an outsider would have to raise $9300 in cash; and D, if he wanted to bid, would have to raise $6300.

If we assume that the house and lot were free from mortgage, and that B and C procured a loan of the $3300 they had to pay by agreeing to give a mortgage on the premises to secure the loan, we have carried as far as we can the analogy to what takes place on the judicial sale of the corporate assets. As we shall see, those who agree to the plan of reorganization eventually buy out, through the device of the judicial sale, those who do not agree; and the buyers finance the purchase on the security of

the enterprise itself; further, that they have the same advantage in the bidding as B and C in the partition sale.

REASONS FOR ASSENTING OR NOT ASSENTING

Why do some of those who have an interest in the corporate enterprise join in the reorganization, and others refuse to do so? Why do B and C, having interests in the business, buy, and why does D, who has an interest, sell?

They may differ in opinion about the future of the enterprise. D may feel that the cash he will get is worth more to him than the participation, whether as creditor or stockholder, he would have in the enterprise under the plan of reorganization.

Probably the division between those who sell and those who buy often arises out of temperamental differences instead of a careful weighing of the prospects of the business. Some feel that as long as they have an interest representing their original investment, they need not consider that they have suffered a loss. They are like an investor who carries his security inventory at cost; he calls a lower current market price a paper loss, and considers that he has not really lost until he has liquidated his commitment into cash, when the loss will have to appear in his bookkeeping. Others feel that a security is worth no more than they can get for it in the market. They are aware that in terms of current value they have already suffered a loss.

All through the course of the receivership, up to the time when security holders no longer have an election to join in the plan or stay out, certificates of deposit and undeposited securities are being bought and sold in the market. A security holder who prefers to take his loss, rather than continue hoping for recoupment by staying committed to the enterprise, may sell his interest, rather than wait to see what he will receive in the corporate settlement. He may believe that what he would then get would be less than the present market price. On the other side, some people may believe that the prospects of the enterprise are such that its securities will show a substantial enhancement in price; and they become the buyers from those who choose to liquidate. In this way the constituency of the groups of security holders may change a great deal. We find throughout corporate affairs a development of devices for the functioning of groups with changing membership.

WHY AN UPSET PRICE IS NAMED

We have spoken of the judicial sale as substantially a sale by those who want to liquidate their interests into cash to those who prefer to retain an interest in the enterprise. The sellers prefer to take the cash they can get; the buyers prefer the interest they can get to the cash they might receive.

On a foreclosure of the ordinary real estate mortgage on a house and lot, the mortgagee commonly becomes the buyer at the sale, because he prefers to own the asset rather than take the amount of cash any other bidder will pay. If the mortgagee were likely to be able to collect on a deficiency judgment, he would ordinarily let another bidder take the property. But the mortgagee is aware that in this instance, as usual, we assume, a deficiency judgment would have no realization value, or one entirely inadequate.

Sometimes mortgagor and mortgagee conclude their relationship by agreement and avoid foreclosure. The mortgagor voluntarily gives a deed of the premises to the mortgagee in full satisfaction of the mortgagee's rights against the mortgagor personally, and thereby saves the mortgagee the expenses of a foreclosure proceeding. An interesting matter of practice may be mentioned. To guard against a possible claim of other creditors that the conveyance creates a fraudulent preference, the deed provides that the lien of the mortgage shall not merge into the title. So the mortgage still remains against the property, and may be foreclosed in the event that other creditors raise difficulties over the conveyance of the equity.

Courts assume that in the case of the ordinary house and lot mortgage they sufficiently protect the mortgagor by the requirement of a public sale in foreclosure. More than one man in the community has the means to purchase, and is likely to buy at a price which is a bargain. Many investors can make commitments of such size.

Foreclosure of a $50,000,000 mortgage presents a different problem. We may assume that the equity of the stockholders has no value. The sale in foreclosure is not really for their protection. Conceivably the stockholders might be willing to authorize a conveyance of the mortgaged assets to the mortgagee, i.e., the trustee for the bondholders. Probably they would not.

a personal liability to protect, and can stipulate to be released from it in consideration of his conveyance; the stockholders have no such liability.

PROTECTION OF UNSECURED CREDITORS IN FORECLOSURE

Although in a given instance it may be obvious that the equity of the stockholders no longer has a value in which they should be protected, there are, nevertheless, equities which require consideration. Liability of the stockholders is limited, and no deficiency judgment can be taken against them as individuals. But the corporation may have substantial assets not subject to the mortgage, and usually it has at least some. A deficiency judgment can be taken against the corporation and claim satisfaction had out of the unmortgaged assets. But it is out of these assets that the general creditor may have hope of some recovery. So the foreclosure should be of such character that it will protect general creditors against an unfairly large deficiency judgment obtained for the mortgage bondholders.

PROTECTING THE NON-ASSENTING BONDHOLDERS

Our analogy of the partition action may be helpful in further picturing the situation. In that proceeding our three tenants in common have the same kind of interest in the property. They are all owners. If the property were susceptible of physical division so that a part, in value one-third of the whole, could be cut off without diminishing the value of the whole, the court, on the application of one of the common owners, might have ordered the premises to be divided in that way. But such a division could not be made. Likewise, in the case of a railroad or of an industrial plant, the property cannot be divided physically so that those who want to retain their interests can keep part and those who want to liquidate their interests into cash can get part to sell. In the partition action the court order of a public auction forces a sale under conditions as fair as conditions permit to all in the common ownership.

So here, in the corporate mortgage foreclosure, we have some parties wanting to retain their interests, others wanting to dispose of theirs. And we have in addition general creditors concerned that the foreclosure sale should be on terms protecting them.

But in the corporate situation does the sole fact of a public sale provide conditions that assure fairness to all? In the partition proceeding the requirements of financing gave the two tenants in common an advantage in the bidding because they had to raise less cash than anyone else. Still, the size of the transaction was such that there well might be some who would have the means to pay the entire purchase price in cash, yet would be ready to buy at a real bargain. And the bargain, nevertheless, might be a substantial proportion of the price the premises would bring in the course of an unforced market for that kind of property.

Difficulties of financing a transaction of such magnitude as the purchase of a property that was once considered security for $50,000,000 create an extreme improbability that anyone will pay in cash a substantial part of the value of the property for use. Only those who already own an interest and therefore need not pay in cash for the value of their own interest are likely to bid.

Experience indicates that there will in fact be only the one bid; that of the representative of those assenting to the plan of reorganization, and so indicating their election to retain an interest in the enterprise rather than take the cash amount they would get for their interest. Under the circumstances, what protects those who want to turn their interests into cash? What protects the unsecured creditors against an unfairly exaggerated deficiency judgment? How can those who are concerned be assured that they will get a deal which is fair in view of all the conditions?

Since it is improbable that more than one bidder will appear, the court names an upset price, or minimum bid which the master conducting the sale is authorized to accept.

GUARANTOR AND THE UPSET PRICE

A guarantor of bonds undertakes to pay on the default of the principal obligor. So the size of a deficiency judgment concerns the guarantor as an important fact in establishing the amount of its loss. If the guarantor pays, it is subrogated to the rights of the bondholders against the obligor corporation; that is, in effect, the guarantor, on payment by it, takes the defaulted bonds from the holders, and, as itself the bondholder, asserts the claim of the

bonds against the issuer. Or, if the bondholders assert their claim against the issuing corporation, they hold the guarantor liable for the balance due them after they have realized all they can out of the corporate assets. The upset price establishes the amount so realizable, and leaves the guarantor to stand the loss of the rest.[1]

DETERMINING THE AMOUNT OF THE UPSET PRICE

Under all the circumstances of a reorganization, what upset price is fair to the bondholders who do not assent to the plan, and to the unsecured creditors?[2] The court will hold hearings, on notice to all parties who have appeared in the proceedings, and will consider a wide variety of facts presented in evidence.

Books of the enterprise may be available to show original cost, and may contain the facts to show depreciation. No such value can properly be determinative. Argument against investment cost as a basis for valuation is an old story. The enterprise has proved that under existing conditions it cannot make earnings which justify the investment.

An engineer's appraisal may be available to show cost of duplicating the identical plant, and to indicate the extent of depreciation. Such valuation amounts to a variation from the investment cost, in showing the effect of changes in the price level. If the level has declined substantially, the value may have some significance. It may show such a reduction from the invested amount that the enterprise could show earnings on the reduced capital value. However, it leaves out factors of possible engineering mistakes in construction, and of the development of invention, or newer ideas in engineering, that would make a new plant, capable of producing the same results, cost much less.

There may be an engineer's report showing the estimated cost of constructing a new plant capable of performing the same amount of work as that done by the existing plant. This would come

[1] Ernest Howard, *Wall Street Fifty Years After Erie*, New York, 1923, presents a critical statement of the failure of the Denver and Rio Grande, guarantor of the bonds of the Western Pacific, to appear at the hearings on the upset price in the proceedings for the foreclosure of the Western Pacific Mortgage.

[2] Joseph L. Weiner, "Conflicting Functions of the Upset Price in a Corporate Reorganization," *Columbia Law Review*, February, 1927, Vol. XXVII, No. 2, p. 132, contains a discussion of the problem.

nearer the mark. But the purchasers at the foreclosure sale are not buying such a plant. Probably the cost of operating it would be substantially less than the operating costs of the existing plant. If the cost of such a new plant is to be considered, the amount, to arrive at a valuation of the assets to be sold, should be reduced by a write-off capitalizing the probably greater cost of operating the actually existing plant.

Present earnings and the reasons for belief in increase or decrease may be presented with the idea of approaching value along the line of a capitalization of earnings as affected by a consideration of prospects.

However, this is not the place to go at length into the problems of valuation. We are just briefly indicating the matters that the court will consider.

MARKET APPRAISAL

In the case of a great corporate enterprise, with its large issues of securities having an active market, the court has another approach to valuation for the purpose of fixing the upset price. As we have seen, the receivership does not end the market activity in these issues. Both undeposited securities and certificates continue to be bought and sold. Their price is the market resolution of the opinions of investors and speculators of the present value of the enterprise in view of its performance and prospects.

MAKING REORGANIZATION POSSIBLE AS ONE OF THE CIRCUMSTANCES AFFECTING FAIRNESS OF UPSET PRICE

One argument has persuasive force. It is important that a reorganization should take place. However willing the receiver, his counsel, and counsel to the committees may be to have the receivership continue, with its accruing claim for fees, the court cannot permanently control the management of the enterprise and keep in force its injunctive decree preventing creditors from resorting to their legal rights. The court has a duty to settle the corporate affairs as advantageously as may be for the creditors. If the plan of reorganization should fail, the work will all have to be done over again. A long delay will take place. Further expenses will accumulate. A high upset price will result in more

cash to each bondholder not joining in the plan, and more bondholders will elect to take cash, both operating to increase the cash requirement. So the bankers may decline to underwrite the plan, and it will fail.

BEGINNING FORECLOSURE

Managers of the reorganization cause the evidence of default to be established through proper presentation and demand for payment of coupons by several bondholders. They furnish the trustee of the mortgage securing the bonds with their affidavits showing such presentation and demand, and the failure of payment.

The protective committee for this issue, having on deposit at least the required number of bonds to give a right under the mortgage to demand that the trustee proceed with foreclosure, adopts a resolution calling on the trustee to foreclose. The secretary to the committee certifies a copy of the resolution and delivers it to the trustee.

Since the mortgage and trust indenture provides that the trustee shall not be required to proceed unless secured to be indemnified for costs and other liabilities, the trustee and the committee agree on the amount of security, and the committee furnishes a surety bond to the trustee in the agreed amount.

By operation of the clause in the mortgage for acceleration of maturity of the principal sum on default in payment of interest, the foreclosure will be for the entire amount of principal and interest due.

We assume that the time has arrived when the court is ready to permit foreclosure to proceed. On application it makes an order granting permission to foreclose.

Decree on the original creditors' bill brought all matters affecting the corporate estate within the jurisdiction of the court. We no longer need to have diversity of citizenship in these "dependent" proceedings. The purpose of the foreclosure is to cut off the equities of all who have an interest in the mortgaged assets. The court having control of this corporate estate can, better than any other, see that this is done in a way to afford every proper protection to all parties. So the bill to foreclose is just part of the primary proceeding under which the court is in control — a dependent bill.

If there is mortgaged property in more than one Federal Circuit, an ancillary bill is presented in each circuit immediately upon the filing of the original bill and intermediate order thereunder appointing the receiver in the foreclosure proceeding.

Usually the mortgagor corporation appears and consents to the foreclosure, and further consents that the receiver operating the enterprise under the creditors' bill be also the receiver in the foreclosure proceeding. Appointment of a receiver in the foreclosure impounds any net earnings from operation for the benefit of the bondholders secured by the mortgage.

FORECLOSURE OF DIVISIONAL MORTGAGES

If, in a railroad situation, there are divisional mortgages — what we have called conflicting liens — these mortgagees are made parties defendant. They would be affected by a deficiency judgment, as having an interest in any unmortgaged assets as well as the bondholders of the mortgage being foreclosed. Also they have an interest arising out of the fact that foreclosure on part of the road will sever the line of continuous operation. If such conflicting divisional mortgages are in default, the bondholders whom they secure can begin foreclosure, which, however, is begun and followed through essentially as part of the first foreclosure proceeding. We will not go into the intricacy of the lawyer's pleadings at this point, as they are not of interest to the layman; it is hoped that the simple statement of this paragraph is near enough to accuracy, and will be understood.

But it is obvious that, if there are two or more foreclosures, there will be separate purchase prices for each property foreclosed. Since, however, in the reorganization process there will be only one bidder, it is the aggregate of these purchase prices which amounts to an aggregate bid. Nevertheless the aggregate cash will be distributed to the non-assenting bondholders in accordance with the price set on the mortgage security of each issue.

PREPARATION FOR DECREE OF SALE

Though we are sketching the foreclosure proceeding in rough outline in the space of a page or two, we should remember that the elapsed time may well run to a year or more. During this period the rights of those claiming adversely as to any property

which the mortgage bondholders assert is part of their security are being threshed out before a master who reports his findings to the court.

Hearings on the upset price are held.

Meanwhile the reorganization management has been getting ready for the sale. It has prepared the plan of reorganization, obtained the approval of the several protective committees, and presented the plan to the court for approval. On notice to all parties concerned the court holds hearings on the fairness of the reorganization plan. We will assume here that the court approves it.

PROMULGATION OF THE PLAN, AND OPPORTUNITY TO WITHDRAW AND TO DEPOSIT

The reorganization management then prints and distributes the plan as approved by the court. So the plan is "promulgated," to use the terminology of reorganization, and all security holders may see what provision it makes for those who assent to it.

Now those who have deposited their securities and are not willing to accept the plan have an opportunity to withdraw their securities from deposit, so electing to take whatever cash may be available for them. Correspondingly, those who have not heretofore deposited are given an opportunity to deposit, expressing their election to take the provision made by the plan.

Reorganization requires the issuance of new securities, and, therefore, the acquisition by a new corporation of the assets of the old enterprise with the equities cut off by foreclosure. So, after the commitment of the bankers becomes definitive, the reorganization managers will proceed to procure the charter of the new corporation.

BANKERS' UNDERWRITING OF THE PLAN MADE UNCONDITIONAL

Heretofore the bankers, pending determination of the amount of liability to be assumed, presumably have kept their undertaking to underwrite entirely tentative, i.e., have indicated that they would underwrite if the maximum cash they would be called upon to provide would not exceed a certain amount. Now, with the fixing of the upset price, and the ascertainment of the amount of securities absolutely committed to the plan, this maximum

liability is determined, and the bankers make their commitment unconditional. The plan has not failed.

DECREE OF SALE

Finally the time arrives for the decree of sale. It states the time and place of sale — on the steps of the county court house in some county in which mortgaged assets lie. Also it states the amount and kind of deposit that must be made as a condition of being permitted to bid. This is required as an evidence of good faith, to prevent mere speculative bids. We have already seen that it provides an upset price, or minimum bid that will be accepted.

EXAMPLE OF SALE AND ITS RESULTS

To illustrate the sale process, we will bring forward the example already presented of a railroad corporation that is in receivership.

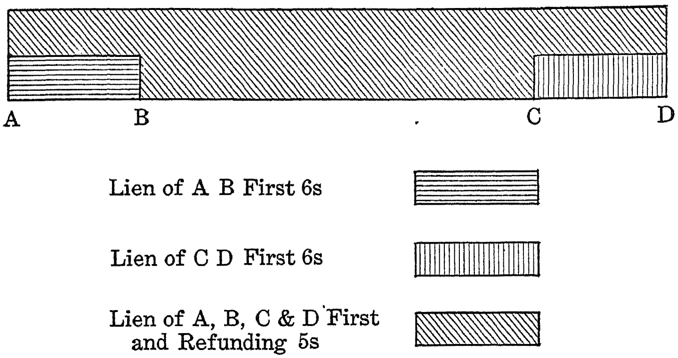
Repeating the facts to bring them immediately before the reader:

The A, B, C & D Company shows on the liability side of its balance sheet the following:

Capital stock		$25,000,000
Accounts and wages payable (representing preferred claims for materials furnished under the six months rule, etc.)		2,000,000
Miscellaneous accounts payable		500,000
Interest matured		1,050,000
Taxes		1,000,000
Funded debt:		
A B First 6s	$10,000,000	
C D First 6s	10,000,000	
A, B, C & D First and Refunding 5s	30,000,000	
Ten-year unsecured notes, 6s	5,000,000	
Equipment 5s	5,000,000	
		60,000,000

In its present form the enterprise shows the result of a consolidation of three corporate enterprises. Two had a mortgage debt before consolidation. One had a floating debt which was paid off. The merger of the three corporations was financed principally through the proceeds of the A, B, C & D First and Refunding 5s, and through the exchange of stock.

A sketch of the property, indicating the mortgage liens, shows:



Since the A B division holds the A terminal situation, interest has so far been paid on the A B First 6s.

The C D First 6s and A, B, C & D First and Refunding 5s are in default.

The receiver has adopted the Equipment Trust agreement. So the Equipment 5s are not in default.

We will assume that in the struggle over the reorganization plan the C D First six per cent bondholders have succeeded in wresting for themselves a little better treatment under the plan than that accorded to the First and Refunding five per cent bondholders. In this bargaining the C D bondholders probably based part of their argument on the fact that their bonds are six per cent and the general mortgage bonds are five per cent. Strictly, in law this is not relevant. The debt that is now due is the principal, by acceleration of maturity, and the interest overdue and accrued to the date of sale. Except for this interest to date the amount due on a $1000 six per cent bond is no more than the amount due on a $1000 five per cent bond. Yet as an obligation of a going concern the C D bonds had a six per cent claim against earnings and the First and Refunding bonds a five per cent claim. The C D bondholders are likely to overlook the fact that the equity protecting them in the six per cent claim is gone. Such differences in interest rates have sometimes been recognized in reorganization plans and sometimes not.[1] In further argument

[1] For consideration of this matter see James C. Bonbright and Milton M. Bergerman, "Two Rival Theories of the Priority Rights of Security Holders in a Corporate Reorganization," *Columbia Law Review*, February, 1928, Vol. XVIII, No. 2, p. 141.

the C D bondholders have gained advantage from the desire of the First and Refunding bondholders to keep the continuous line from A to D.

We have introduced the matter at this point simply because of its relationship to the upset price on the C D division as compared with the upset price on the line for A to C subject to the A B and C D mortgages. For we are assuming that after the First and Refunding bondholders began their foreclosure, the C D bondholders presented their cross bill to foreclose. Then, on hearings to determine the respective upset prices, they succeeded in having a higher value placed on their property in proportion to the debt secured than on the property of the First and Refunding bondholders. For their possible arguments we would refer to the earlier discussion of arriving at the upset price.

CHANGES IN THE BALANCE SHEET IN THE COURSE OF THE RECEIVERSHIP

Let us assume that by this time two years have elapsed since the default which precipitated the original receivership under the bill in equity, and that various changes have taken place in the liabilities of the enterprise. The receiver, under authority of the court, has issued $1,500,000 receiver's certificates to pay off the tax accumulations and make necessary repairs. Unpaid expenses of the receiver are $250,000, and expenses of the proceedings are $750,000, an aggregate of $1,000,000. The one overdue instalment of interest on the First and Refunding bonds and on the C D bonds is now four instalments of interest overdue.

Changes in the assets include an accumulation by the receiver of cash and accounts receivable in the amount of $1,500,000, and (for the sake of simplicity in our example) we will assume that foreclosure proceedings were instituted so early that all these cash items are impounded for the benefit of mortgagor bondholders. We will also assume that, owing to the nature of the enterprise, railroading, and the operation of future acquired property clauses, there are no unmortgaged assets. Actually such assets would be of small amount, and for simplicity we are assuming there are none. So, for purposes of foreclosure, we have this picture (not a statement of total assets and liabilities, but of those relevant to the foreclosure):

Liabilities

Expenses of the receiver and of the proceeding	$1,000,000
Receiver's certificates	1,500,000
Other preferred claims chargeable against mortgaged assets	2,000,000
Total preferences chargeable to the mortgage funds	4,500,000
C D First 6s	10,000,000
First and Refunding 5s	30,000,000

Assets

Cash and receivables	1,500,000
Railroad	

As a result of hearings on the upset price it has been fixed at $8,000,000 in the First and Refunding foreclosure and at $4,000,000 in the C D foreclosure. These figures are adopted for the sake of simplicity, and to indicate merely some difference in the relative values of the two bonds. Further, we are assuming, with figures again chosen for the sake of simplicity of the problem, that the payment of the preferred claims will be charged against the two divisions in the proportions of the upset prices, so that one-third will come out of the C D fund and two-thirds out of the assets applicable towards the satisfaction of the First and Refunding bonds. We can consider the price to be paid for the properties in foreclosure as part of the fund. The fact that most of the bondholders will take new securities rather than cash is for the moment irrelevant. The result will be:

C D Fund

From price in foreclosure	$4,000,000
From cash assets on hand	500,000
Total fund	$4,500,000

In accordance with our division of responsibility for preferences we have the following:

Allocation of the C D Fund

To pay preference claims	$1,500,000
For bondholders	3,000,000
	$4,500,000

Or, if the entire upset price were paid in cash, the C D bondholders would receive thirty cents on the dollar.

First and Refunding Fund

From price in foreclosure	$8,000,000
From cash assets on hand	1,000,000
	$9,000,000

Allocation of First and Refunding Fund

To pay preference claims	$3,000,000
For bondholders	6,000,000
	$9,000,000

Or, if the entire upset price were paid in cash, the First and Refunding bondholders would receive twenty cents on the dollar.

AMOUNT OF BONDS LEFT ON DEPOSIT AFTER PROMULGATION OF PLAN

Now we must make a further assumption, namely, of the amount of bonds the reorganization management has in possession after the promulgation of the plan of reorganization, opportunity given to withdraw, and time extended to deposit. We will set these amounts as follows:

C D First 6s	$9,000,000
First and Refunding 5s	28,000,000

Since the representative of the reorganization management bidding at the sale will be able to pay in large part in bonds at their value as established by the bid price, we have now ascertained the amount of cash necessary for the purpose of purchase on a bid of the upset price.

C D upset price	$4,000,000
First and Refunding upset price	8,000,000
Aggregate	$12,000,000

This can be paid as follows:

$9,000,000 C D 6s at 30 cents	$2,700,000
$28,000,000 First and Refunding 5s at 20 cents	5,600,000
Cash	3,700,000
	$12,000,000

SALE

Finally the day of sale arrives. The special master, on the steps of the county court house designated in the decree ordering

Assets	
Cash and accounts receivable	$2,200,000
Inventory	14,000,000
Plant	50,700,000
	$66,900,000

Liabilities	
Notes and accounts payable	$5,400,000
Preference claims, expenses of receivership and of reorganization, chargeable against mortgaged assets	1,500,000
C D First 6s	10,000,000
A, B, C & D First and Refunding 5s	30,000,000
Capital stock	20,000,000
	$66,900,000

No attempt has been made to indicate any probable situation. Figures have been taken simply for the sake of clarity.

Such a capitalization developed in this way: The A, B, C & D Company was incorporated to acquire, and did acquire, the assets of the predecessor A B Company and the C D Company. It effected the purchase through the issuance of its First and Refunding bonds and its capital stock. The C D First 6s represent a mortgage on one of the plants acquired, and were assumed by the consolidating company. The A, B, C & D First and Refunding 5s are secured by a first mortgage on the A B plant, and a second mortgage on the C D plant. Default was made on both bond issues. Taxes have been paid, and no receiver's certificates issued. For simplicity we are neglecting the overdue and accrued interest. We assume that of the cash and accounts receivable $1,000,000 represents the amount impounded for bondholders in the foreclosure receivership; the other $1,000,000, and the $14,000,000 inventory, are unmortgaged assets. (We will remark that presumably the mortgage might have been made in effect a floating charge to clamp down on this inventory on default, but we are assuming that the indenture was not so drawn.)

We can now effect a segregation of the funds.

Unmortgaged Assets	
Cash and accounts	$1,000,000
Inventory	14,000,000

Claims against Unmortgaged Assets before Foreclosure

Notes and accounts payable	$5,400,000

Mortgaged Assets, Including Amount of Net Earnings Impounded

C D Plant	
A B Plant	
Net earnings (one-third for C D bondholders, two-thirds for A B bondholders)	$1,200,000

Claims against Mortgaged Assets

Preference claims, expenses of receivership, foreclosure, and reorganization	$1,500,000
C D First 6s	10,000,000
A, B, C & D First and Refunding 5s	30,000,000
Now assume that the upset price on the C D plant (which is charged with one-third of the preferences) is	$3,500,000
And the upset price on the A B plant (which is charged with two-thirds of the preferences) is	$7,000,000

Deficiency Judgment

C D

Mortgage debt	$10,000,000
Share of preferences	500,000
	10,500,000
Sale price	3,500,000
	7,000,000
Satisfied by impounded earnings to the extent of	400,000
Net deficiency	$6,600,000

A B

Mortgage debt	$30,000,000
Share of preferences	1,500,000
	31,500,000
Sale price	7,000,000
	24,500,000
Satisfied by impounded earnings to the extent of	1,000,000
Net deficiency	$23,500,000

Since this proceeding is in bankruptcy, only the deficiencies as shown above are claims provable for satisfaction out of the unmortgaged assets, against which we now have total claims as follows:

Notes and accounts payable	$5,400,000	
Deficiency C D	6,600,000	
Deficiency A B	23,500,000	
	$35,500,000	
Unmortgaged assets	$15,000,000	
So unsecured creditors will receive on the dollar		$.4225
C D bondholders will receive —		
Out of mortgaged assets on the dollar		$.30
Out of unmortgaged assets		$.4225
		$.7225
A, B, C & D First and Refunding bondholders will receive —		
Out of mortgaged assets on the dollar		$.20
Out of unmortgaged assets		$.4225
		$.6225

CHAPTER XLIII

Plan of Reorganization

Presentation of the foreclosure process, with its concomitant of an upset price, as part of the settlement of the affairs of a corporation in default, has shown the pivot on which a reorganization turns.

COURSE OF PREPARATION OF THE PLAN

Probably preparation of a plan of reorganization will follow somewhat this course: counsel, in consultation with the bankers, will prepare a draft, which, in its final form, the bankers will submit to the reorganization committee. This committee will consider it, confer with the bankers and lawyers about it, and come to an agreement, with the result of a further revised draft to be submitted to the protective committees. Then the process of negotiation will begin. We will assume that objections can be met or overcome, and such further revision of the plan effected that finally the protective committees are willing to accept it for recommendation to their respective groups, and the bankers feel that it is still such a plan as they can underwrite.

PROBLEMS FOR WHICH THE PLAN MUST PRESENT A SOLUTION

Such a plan must propose a solution for several problems:

(1) It must adjust the conflicts among the classes of claimants on such terms of continuing interest in the enterprise as are likely to win the adherence of the several groups.

(2) It must show a present cutting down of fixed charges.

(3) It must effect the adjustment in such a way that each class of security holders obtains a greater interest in the continuing enterprise than any class junior to it.

(4) It must provide for raising the necessary cash.

As we shall see, these problems are not completely severable, but are all to some extent interrelated.

TERMS OF CONTINUED PARTICIPATION IN THE ENTERPRISE

We have already seen something of the problem of adjusting the conflict of interests of bondholders secured by divisional mortgages. Since this is a matter of bargaining dependent on the facts in each case, it affords little opportunity for general discussion.

Next we have the matter of the kind and amount of securities to be offered to each class of interest. Both kind and amount are part of the problem of cutting down fixed charges. However, we may properly discuss at this point some general considerations of satisfying the security holders.

PSYCHOLOGY OF FORECLOSING BONDHOLDERS

Here we encounter a matter of investor psychology that interposes a great obstacle to sound reorganization. A bondholder is very reluctant to give up his creditor position. He wants to feel that he continues to have a right to interest and to repayment of principal; in other words, he wants to go on in the comforting feeling that he need not necessarily consider that he has suffered a loss. He overlooks the fact that the conditions which gave his creditor rights their special value no longer exist. He contracted for a limited participation in the earnings of the enterprise on condition that the equity interests would protect him in the full amount of his limited return; would repay his principal, and would suffer complete loss before he suffered any. The equity interests now afford no such protection. They did protect him as long as they had any value, but default has taken place.

DESIRABILITY OF FORECLOSING BONDHOLDER ASSUMING POSITION OF OWNER

The investor ought to recognize his situation. He ought to see that he is in the position of the ordinary house and lot mortgagee, and in foreclosure take over the property as owner. A holder of a bond in default cannot get anything more than all

there is. If he converts his position of bondholder into that of stockholder he takes all. He is entitled to it. The equity interests have failed to protect him. Though the equity has no immediate worth in present income producing capacity, it carries the speculative chance of future earning power, and of greater enhancement in value as measured by the market price of stock than substituted bonds would have, measured by market price. If the foreclosing bondholder would take shares of stock in the reorganization to replace his creditor securities, he would gain the entire market enhancement that is gained under the usual plan by bondholders and stockholders together. Since the owner of the equity has defaulted, the creditor should get such compensation as he can by acquiring its potential values.

FORECLOSING BONDHOLDERS WILL NOT SUPPLY NEW CASH

Here again this problem of reorganization is complicated with another problem of the plan — that of provision of the cash requirements. A house and lot mortgagee knows when he sets out to acquire the premises in foreclosure that he will have to pay off tax liens and the expenses of the proceeding. In some way he will have to raise the necessary amount of cash. If he does not have it available from his own funds, perhaps he can raise it by giving a new first mortgage, which will be good security for the size of the loan he seeks.

Holders of bonds in default are very reluctant to put up new cash, and will not do so if any way can be found to preserve an interest in the enterprise for them without their making any cash provision. It is only when a security holder cannot get anything at all, unless he puts up cash, that he will part with additional funds to protect his investment.

SEEKING CASH FROM JUNIOR INTERESTS

Why, however, is not the device of a new senior mortgage, securing bonds to be sold for cash, available and adequate? It is available, and commonly the plan of reorganization resorts to it. But this is only part of the story. Since an issue of bonds provides a means for raising cash, and not the cash itself, someone must sell the bonds. The bankers underwriting the plan of re-

organization must assume the responsibility for cash provision. They want the burden lightened as much as possible. To this end they commonly seek to have some bait for junior security holders to purchase bonds of the senior issue provided for cash requirements.

The usual device is to give such claimants — junior bondholders, general creditors, preferred and common stockholders — a participation in the new stock conditional on their purchasing bonds, usually at a more favorable price than will be made to outside investors. To the extent that securities for cash financing are marketed in this way, the bankers are relieved from the labor of selling. It well may be that they would not undertake the underwriting of the plan without such provision in it. So new stock is reserved for this purpose, and, perhaps, in some proportion, as part of the underwriting commission.

All this is natural enough. But perhaps a plan could be worked out that could be underwritten, and still adjust the equities more fairly, if it were not for the ostrich-head-in-the-sand attitude of investors who, refusing to look at facts, persist in continuing as creditors. If the bankers will not undertake to market securities necessary for cash without the aid of junior claimants, might it not be better business for the foreclosing bondholders to abandon their creditor position, gain the equity, and relinquish some of it, i.e., part with some of the shares, if necessary, to induce junior claimants to provide cash? Possibly this would be objectionable under the principles of the Boyd Case, which we will discuss later.

In our next topic, the problem of reducing fixed charges, we will consider further the kind of securities to be issued.

REDUCING FIXED CHARGES

Bondholders, we have said, want to feel that they may not ultimately suffer any loss at all. They want the same obligation for principal, the same interest rate, the same security, that they have, and they want the enterprise to prosper so that it can fulfil these obligations. But the business has shown that it cannot under present conditions support such charges. To take it out of receivership and continue the full interest would simply result in an immediate further default. So the charges must be reduced if the enterprise is to continue meeting them.

Since new cash must be raised for the reorganization, and the only credit strong enough to provide it lies in giving a security ahead of the bonds in default, such new bonds will create a new charge, which must be taken into account in determining the amount of reduction the foreclosing bondholders must suffer.

Again we encounter the psychology of investors. If they must sacrifice either interest or principal in the endeavor at reduction of fixed charges, they would rather sacrifice interest than principal. The fact that mathematically one is the same as the other does not matter: \$858.20 in a twenty-five-year bond at five per cent comes to the same thing, in the mathematics of investment, as \$1000 in a twenty-five-year bond at four per cent; but it does not come to the same thing in the mind of the investor.

Indeed, the reaction of the investor is sound enough. Assume that he paid \$1000 for the bond he holds, which carries interest at the rate of five per cent. If its value at the time of reorganization is such as to be convertible into a four per cent bond of the face amount of \$1000, that means the investor has lost, in terms of present value as compared with cost, the sum of \$141.80. By accepting the four per cent bond the investor hopes to build his principal again.

So, in the hope that the enterprise will prosper, and ultimately be able to meet the maturities of its new obligations by refinancing, or otherwise, the foreclosing bondholders tend to insist that their principal be not reduced. Fifty years is a long way off, and if for the present the enterprise can wear its fixed charges, however tight a fit, the debt will serve very well. After us, if ever, the deluge.

Certain devices are commonly used to reduce the payments of interest to the foreclosing bondholders.

ADJUSTMENT BONDS

One of the commonest is the adjustment bond. Such a bond will carry a low rate of interest for the first few years, and step up the rate each few years until it reaches the maximum — as two per cent for two years, three per cent for two years, four per cent for one year, and four and one-half per cent thereafter. Reorganizations take place during periods of depression. Those who are caught in the failure of a business hope that, with an

improvement in general conditions, the affairs of the enterprise will prosper enough to enable it to respond to the advancing interest rates of the security offered under the plan. The word "adjustment" becomes part of the title of the bond, which is known by that name even after there is no more adjusting to do. If all goes well, and the enterprise prospers, such a bond may come to be highly regarded in the investment market.

INCOME BONDS

Income bonds afford another device for reducing fixed charges. Their promise is to pay interest at, or up to, a certain rate, if earned. If earnings are not available the corporation is not obliged to pay. Commonly the income condition of the promise is limited to a period of a few years, and the interest becomes an absolute obligation at a stated rate after that time. The bonds have a fixed maturity, and the promise to pay principal is unconditional. By utilizing such a security the reorganization management hopes that the enterprise will tide over present misfortunes to an improvement in its affairs.

Bonds of this kind have a usefulness at times, but should be used only as a last resort. They may turn out to be a license for a law suit. Determination of net income available for interest presents elusive possibilities. Reasonable variation in business judgment allows a good deal of leeway in various items of deductions from gross in arriving at net income. What is proper maintenance? At what point does a replacement include a betterment? What are proper reserves for bad debts? These are matters of practice. No elaboration of defining earnings in a trust deed can fully protect the holders of income bonds.

Stockholders elect the directors who appoint the executive officers. These directors and officers are not fiduciaries for all parties in interest, and are unlikely to consider the corporate assets as a trust fund to the extent of making nice distinctions between principal and income. If they observe their duty not to do anything to impair capital stock, they may feel that they have done all that is required of them. The obligation on the income bond is contractual, and failure to apply income is a breach of contract, not a violation of a trust. Every dollar saved through the undercomputation of net income becomes a dollar for the benefit of stockholders. Since the usual income

bond is not cumulative, the advantage to the common stockholder, of not paying out dollars to the bondholders, is greater than in the case of cumulative preferred stock, on which a withholding of dividends, instead of keeping the principal for the common stockholders, only gives them the benefit of the use of capital without paying for it.

Central of Georgia Railway furnished a still interesting example of the income bond.[1] That corporation had outstanding three issues, all put out in 1895 and due in 1945. They were non-cumulative and bore interest, payable only if earned, at not exceeding five per cent in any one fiscal year. The corporation did not pay the full five per cent on the first incomes till 1901, paid only three per cent in 1902, then five per cent till 1908. It did not pay anything on the second incomes till 1904, then two per cent; five per cent in 1905 and 1906, then stopped paying. On the third incomes it paid five per cent in 1905 and 1906, then ceased paying. The income bondholders took the matter into the Supreme Court of Georgia. An auditor appointed by the court found that the railway company had kept back $542,000 net income of a subsidiary, the Ocean Steamship Company, and other items, making a total of $860,909 available beyond what the corporation itself had shown. The court thereupon held the company liable for full interest on the three classes of income bonds from earnings of 1906–07; and in February, 1911, the corporation paid the balance of 1.27 per cent on the second preferred and the five per cent on the thirds.

In November, 1909, the bondholders again brought action to recover full interest on the three classes of bonds from the earnings of 1907–08. In May, 1911, the company offered to pay, and did pay, full income of the firsts for 1908, and 2.821 per cent on the seconds; and for 1909 and 1910, 2.312 per cent on the firsts.

During this period the operating ratio of the road ran as follows:

1900	*1901*	*1902*	*1903*	*1904*
66	69	71	74	73
1905	*1906*	*1907*	*1908*	*1909*
72	70	76	74	79

The increase in the ratio in 1907, when the road reduced the payment on the seconds, and omitted it on the thirds, in the

[1] This example is also presented in Hastings Lyon, *Corporation Finance*, Book I, p. 40. Houghton Mifflin Company, Boston, 1916.

next year not paying on any, would raise a question whether or not the company, in addition to holding back the earnings of its subsidiary, was not also, under the guise of maintenance, sinking earnings in really capital expenditures expected to show results later in the form of dividends on stock. Of course the analysis should go further to consider the variations in gross through these years. For we have seen that operating ratios tend to increase as gross declines.

NEW BONDS WITH LOWER INTEREST RATES

A plan of reorganization may simply provide for the foreclosing bondholders a new bond with a lower interest rate, and not including the adjustment or income features. Usually, however, there is a feeling that later the enterprise will be able to pay a higher charge than it can stand immediately, and through the adjustment or income devices the foreclosing bondholders reach out for this much of the speculative values which they might have appropriated entirely by assuming the position of stockholders.

PARTICIPATION BONDS

Participation bonds might be used for the purpose of cutting down fixed charges. But it is generally felt that, if the readjustment is to take the form of a participation in earnings beyond charges, a part stockholder interest better serves the purpose. The two aspects of interest in the enterprise can then be dealt with, bought and sold separately.

PREFERRED AND COMMON STOCK

So far we have mentioned securities which the plan of reorganization is likely to provide for the foreclosing bondholders. Since in legal contemplation the foreclosure cuts off the equity of the junior security holders, then, if they were cut off in fact, fixed charges would be reduced by the extent to which they have held creditor instruments. We will consider their position further in connection with another problem of the plan. As we shall see, it is generally hoped that they will furnish some cash in order to retain an interest in the enterprise. To induce them to put up the cash, they are offered stock in substitution for their old securities.

UNDER THE PLAN EACH CLASS OF SECURITY HOLDERS MUST OBTAIN A GREATER INTEREST IN THE CONTINUING ENTERPRISE THAN ANY CLASS JUNIOR TO IT

Our caption states a very broad generalization to introduce a problem of the plan that requires a good deal of explaining. Perhaps the heading is too broad, and it is necessary only that no class of junior security holders is given an interest unless each class of security holders senior to it also is given an interest; perhaps the idea of a greater interest does not apply as between classes of stockholders. Let us see the statement of the principle in the words of Robert T. Swaine.[1]

> The rule as I see it, and as I believe it will ultimately be developed by the Courts, is that the relative priorities of the old securities, senior to the most junior securities which continue to have an interest in the property, must not be inequitably disturbed. Stockholders cannot be put ahead of creditors. Unsecured creditors cannot be put ahead of bondholders; and, it is submitted, common stockholders cannot unite with bondholders in a plan which will put them ahead of preferred stockholders.

With this we come to a topic commonly known as the doctrine of the Boyd Case.[2]

DOCTRINE OF LAW

We have seen the bondholders foreclosing their mortgage, and the reorganization committee buying the property at the sale. At that moment the assenting bondholders become essentially the owners. If the holder of a mortgage on a house and lot should buy the premises in foreclosure, he, as owner, could then

[1] "Reorganization of Corporations: Certain Developments of the Last Decade, Part I," *Columbia Law Review*, December, 1927, Vol. XXVII, No. 8, p. 907.

[2] *Northern Pacific R. R. v. Boyd*, 228 U. S. 482 (1913), 33 Sup. Ct. 554. For discussion of the doctrine and indication of further cases see James C. Bonbright and Milton M. Bergerman, "Two Rival Theories of the Priority Rights of Security Holders in a Corporate Reorganization," *Columbia Law Review*, February, 1928, Vol. XVIII, p. 146; J. N. Rosenberg, R. T. Swaine, and R. Walker, *Corporate Reorganization and the Federal Court*, Baker Voorhis, New York, 1924, p. 37 and *passim;* Paul D. Cravath, *Some Legal Aspects of Corporate Financing, Reorganization and Regulations*, The Macmillan Company, 1917, p. 191; Robert T. Swaine, "Reorganization of Corporations: Certain Developments of the Last Decade, Part I," *Columbia Law Review*, December, 1927, Vol. XXVII, No. 8, p. 901.

make any disposition of them he saw fit. He could give them away. He could give anyone a half interest, or any other interest in the ownership. He could bargain before foreclosure to dispose of any part of the ownership he would or might acquire at the sale, and for any consideration, adequate or inadequate, he saw fit.

Prior to the foreclosure the mortgagor owned the equity. Judgment creditors may have obtained liens subject to the mortgage. Tenants may be in possession under leases given subsequent to the mortgage. If all these people having interests in the property were made parties to the foreclosure proceeding, they are cut off. The mortgagor has lost every trace of ownership. The judgment creditors have lost their liens. The tenants can be forced to vacate. After the sale none of these have any rights in the property for the purchaser to respect.

Before the Boyd Case, reorganization managements on foreclosing assumed, as representatives of the assenting bondholders, that they were in the same position as the individual mortgagee who has bought at his own foreclosure sale. Since the Boyd Case, reorganizers are aware that they are not entirely free to bargain away their prospective ownership. Though they may presumably give it away to a total stranger if they see fit, they may not, without regard to the principles indicated in the preceding topic, give it to those whose interests are being foreclosed.

DOCTRINE OF EQUITY

Some fifteen years after the reorganization of the Northern Pacific Railway Company, Boyd, an unsecured creditor of that corporation, sued the reorganized Northern Pacific Railroad Company. Though the plan of reorganization provided for the participation of stockholders, on payment of cash, it made no provision for unsecured creditors. Boyd took the position that the foreclosure sale was void as to him, and that he had a good claim against the new corporation for his debt. In spite of defendant's argument (*inter alia*) of laches for delay in prosecuting the claim, the Supreme Court of the United States decided in favor of Boyd.

This case established the principle that stockholders may not participate in a reorganization unless creditors junior to the foreclosing bondholders are also given an opportunity to participate.

And this is so even though the plan calls for cash payment by the stockholder of all that ordinary judgment would find that the participation is worth. The privilege of subscribing to the new securities is in itself apparently an interest in the equity.

It may be argued in support of this last statement that the subscribing stockholders would not participate, unless they believed that they were getting something of more value to them than the amount of money they have to pay for it; that the very fact of their subscription is an evidence of the retention of some equity, however slight; and that therefore there were values which should have been applied to the general creditors. The fact that the terms on which the new securities are offered to the old stockholders are usually by way of bait somewhat better than those on which they are offered to outsiders would seem to support this argument.

But consideration should be given to the underwriter's commission, i.e., the net terms to the corporation. And of course there are no such values applicable to general creditors, unless the values allowed to stockholders would have more than satisfied the foreclosing bondholders. Unless that is the case, any values received by the stockholders are given to them out of values belonging to the bondholders, and not a misapplication of values belonging to general creditors. Under legal doctrine the bondholders have a right to dispose as they see fit of values belonging to them.

Perhaps it might be difficult to determine whether or not the bondholders were giving away something belonging to them, or, forsooth, disposing of an equity belonging to general creditors. If the bid price at the foreclosure is less than the face amount of the foreclosing bond issue, it would seem to be clearly established that there was no equity for junior claimants. The fact that part of the purchase price is paid in bonds is in form a mere procedural convenience. And in practice it merely enables the bondholders to make a higher bid than anyone else would make. So from the law viewpoint it would seem clearly to establish that there was no surplus value to create an equity for junior claimants.

Equity jurisprudence, however, has chosen to express a belief that principles which may be deemed to operate justly in the foreclosure of a $5000 mortgage may not operate justly in the foreclosure of a mortgage securing a $50,000,000 bond issue. It

can no longer rely on the idea that a public sale establishes values which are fair under all the circumstances. In the case of the large bond issue the bid price has lost much of its probative force in showing fairness. It is in result the upset price, and, as we have seen, one of the forces shaping the amount of the upset price is that it should be small enough to enable the bankers to underwrite the plan of reorganization, a matter which may not have a close relationship to value. And there is the possibility of collusion between the foreclosing security holders and the stockholders to cut out the intermediate claimant. So equity has enunciated the principle which we call the doctrine of the Boyd Case.

PROVISION FOR CASH REQUIREMENTS

Cash requirements of the foreclosure may be summarized as: (1) The payment of administrative expenses, i.e., the expenses of the receiver, the expenses of reorganization, including those of the protective committees, the reorganization committee, fees of counsel of the receiver, and of the committees; (2) the payment of preference claims having a right to satisfaction out of the mortgaged assets; (3) payment of bondholders who do not assent to the plan of reorganization, and therefore have a right to their pro rata in cash.

Such foreclosure cash, however, does not complete the cash provision necessary for the reorganization. No enterprise can go on without some liquid capital. Whatever of such capital the enterprise had at the moment of foreclosure sale, we have seen in the process of being absorbed in the foreclosure proceedings. Though under some circumstances the reorganization corporation might take over a little working capital, it would seldom, if ever, be sufficient to carry on the business. Besides, very likely some improvements to plant, or repairs beyond those the receiver found it necessary to make, may be essential to convert the property into one profitable to operate. So we see that the plan of reorganization must provide the means for raising not only the cash required in the foreclosure, but also whatever working capital may be necessary.

Fundamentally providing cash for the reorganization presents as simple a practice as that of the foreclosing house and lot mortgagee, who, on the security of a new first mortgage, borrows two thousand dollars to pay tax liens, the expenses of the proceeding,

and to provide enough funds to put the premises in such order as to be rentable. Application of this practice to the amounts involved in a corporate reorganization, with the ramifications of group financing, and with regard to the doctrine of the Boyd Case, becomes somewhat complicated.

In the first place, the security available to be offered may not be so good as that of the individual who is foreclosing a $10,000 mortgage and giving a new first mortgage for $2000. Often in the corporate situation it is essentially a junior mortgage which is being foreclosed, and of course junior mortgages can give no priority superior to that which they are foreclosing. If their lien is a second mortgage, they can give only a new second mortgage, which is better security than the one in default only to the extent that it is smaller.

Then there is the complication arising out of the amount of cash required, which makes necessary the formulation of a group lender. Funds must come from many individuals. Since ultimately there is no single lender, someone must immediately, though temporarily, occupy the position of such a lender, and promise the money. Foreclosure sale cannot take place unless the purchase price funds are certain. If they were assured, it would still be imprudent to go forward with the foreclosure unless the necessary additional capital were certain. So the bankers form a syndicate to underwrite the securities which the plan provides as a means of meeting the total cash requirements.

But the bankers will not take the risk of underwriting the plan unless it offers bait to the interest being foreclosed to provide part of the cash by purchasing some of the securities which the plan makes available for cash sale. The bankers agree to buy all those which the junior interests do not take up, and hope that these interests will in some substantial measure relieve them of the burden of disposing of the new bonds that must be sold to someone. So those who are formulating the plan offer junior security holders, general creditors, and stockholders, participations in the reorganized enterprise on condition of their paying cash, for which they will receive shares of stock and new financing bonds. In formulating the proposals to these junior interests the reorganization management must observe the principle of the Boyd Case.

The Street often speaks of these offers of participation as assessments. Like much financial terminology the word is loose,

but its use in an understood connection does no harm. There is no right to demand cash from these junior interests: only an offer to them which they need not accept.[1]

COURSE OF MARKET IN SECURITIES OFFERED TO JUNIOR INTERESTS

Often within a few months after the date of foreclosure sale, the securities which the junior interests acquire are quoted in the market at prices lower than they paid in the reorganization. This happens so often as to raise a question whether it would not be advantageous for one having such an interest to refrain from participating. That does not follow. Such a course would be merely the speculative endeavor to catch the low of the market, and would be subject to all the speculative hazards of hopes and fears. When the bottom is reached, the speculator may not recognize it. No shining copper appears as a signal.

If the holders of the junior interests believe that the future of the enterprise affords a good speculation, they may well participate in the reorganization. We observe the same temperamental division of such holders as of the holders of the foreclosing bond issue. Some of the junior interest holders are weary of the worry of an embarrassed enterprise, and prefer taking total loss of their past commitment rather than risk any additional funds. Others persist in their faith in the enterprise, and participate in the reorganization. Only the more experienced are likely to be guided by a really reasoned consideration of the risks in the reorganization as compared with all other risks available for speculation.

PLAN OF REORGANIZATION AND CONCEPT OF CAPITAL STOCK

How does the concept of capital stock fare in reorganization? Not well, but probably on the whole increasingly better. We have a property which, under existing circumstances, obviously does not have a value equal to the total capitalization. Indeed, the foreclosure establishes legally the fact that the old corporation no longer has any capital stock. Foreclosure determines that

[1] Arthur Stone Dewing, *The Financial Policy of Corporations,* Third Edition, Ronald Press, New York, p. 1180, presents an analysis of securities offered to junior interests in many reorganizations.

there are no values in the mortgaged assets remaining for shareholders or any creditors junior to the foreclosing bondholders. Unmortgaged assets do not satisfy creditor claims. Yet in payment for the total assets the new corporation debonairly issues total securities in the aggregate seldom enormously below the aggregate of the old securities.[1]

If comparison of the aggregate par amount of new securities were made with the upset price, which purports to be a viewpoint, the disparity between value and issued stock would appear even greater. Courts have given some judicial recognition to the idea that the principle of the creation of capital stock, i.e., that it shall be issued only for property of a fair value equal to the par of the stock, is not binding in reorganizations.[2]

Supervision by administrative bodies of the issuance of securities, as the Interstate Commerce Commission, the various State public utility commissions, Blue Sky Law authorities, and now the new Federal Commission under the Securities Act of 1933, probably tends to reduce the discrepancy between value and the aggregate of securities issued in reorganizations. There is no inherent impossibility of having such security issuance accord with the capital stock concept. The psychology of investors presents obstacles. With a greater willingness to accept the facts of the situation and assume the position of owners, a plan could be formulated that would preserve the reality of capital stock. No par shares, or shares with low par value, could provide sufficient units of interest to make an offer to everyone who is now invited to participate.

[1] Arthur Stone Dewing, *The Financial Policy of Corporations*, Third Edition, p. 1219, *n.*, refers to various analyses of the new capitalization as compared with the old.

[2] *Sioux City, etc., R. Co. v. Manhattan Trust Co.*, 92 Fed. 428, 34 CCA 431, cited in *Corpus Juris*, Vol. 14, p. 447, *n.*, as holding, in connection with a constitutional provision that stock shall be paid for in full at its par value either in money, labor or services, that:

> Notwithstanding such a constitutional provision, it has been held that stock and bonds in a railroad company issued in pursuance of a reorganization scheme, in exchange for stock and bonds of another corporation, the property of which the issuing corporation was organized to acquire, which latter bonds were not shown to be invalid, would not be held to be invalid, because at the time of the exchange the cash value of the physical property and privileges acquired by the reorganized corporation was not fully equal to the par value of the securities issued in exchange for them.

EXAMPLE OF PLAN

Just to present a hypothetical illustration of the working out of the problems we have discussed in this chapter, let us pick up the facts of our example of foreclosure sale, in the situation showing unmortgaged assets, presented at the close of the preceding chapter. To make the facts of the business situation complete, we should assume an income account, but to shorten the presentation we will assume that the values established for foreclosure sufficiently indicate the extent of the failure. We are assuming a situation that is really too good, and too little complicated, to use as a fairly full illustration of working out a plan, yet for that very reason keeps the present example simple. However, understanding that it is not typical, but merely a convenient frame for some figures, we will proceed.

The situation showed the following liabilities outside of those claims and expenses definitely established to be satisfied in cash in the foreclosure (i.e., omitting cash requirements for non-assentors).

Notes and accounts payable	$5,400,000
C D First 6s	10,000,000
A, B, C & D First and Refunding 5s	30,000,000
Capital stock	20,000,000

Prospective foreclosure presents the following anticipated cash requirements aside from the amount to satisfy non-assenting security holders (including unsecured creditors), the amount of which will not be known until after promulgation of the plan.

C D share of preferences	$500,000
Impounded earnings	400,000
Net cash needed	$100,000
A, B, C & D share of preferences	$1,500,000
Impounded earnings	1,000,000
Net cash needed	$500,000
So in the foreclosure, aside from the claims of non-assenting holders, cash will be required in the amount of	$600,000
Estimated to satisfy anticipated non-assenting claims	$575,000
To provide the reorganized corporation with working capital and make certain improvements expected to result in increased earnings	$2,000,000

We must remember that we are back at the point of time of completing the formulation of the plan, the moment of promulgation. For the plan must be finished before it can be known what percentages of the several interests will assent.

It proposes the following authorized capitalization of the reorganized enterprise:

New First Mortgage 5s	$5,000,000
General and Refunding mortgage adjustment bonds, 2% for one year, 3% for two years, and 4% thereafter, authorized $45,000,000, $5,000,000 reserved to refund First Mortgage 5s, to be presently issued	40,000,000
Unsecured five-year notes 4%	5,400,000
Preferred 6% stock	3,500,000
Common stock, no par shares	150,000

The plan includes the provision of the First Mortgage 5s for cash requirements, and makes the following offers:

(1) To general creditors, for the surrender of each $200 of claims and $75 cash, to receive $100 face amount of First Mortgage 5s, $200 face amount of five-year notes, and one share of stock;

(2) To stockholders, for each $1000 par value of stock and $75 in cash, to receive $100 face amount of First Mortgage 5s and five shares of common stock;

(3) To holders of C D First 6s, for each $1000 face amount, to receive $1000 face amount of adjustment bonds and three shares of six per cent preferred stock;

(4) To holders of A, B, C & D First and Refunding 5s, for each $1000 face amount, to receive $1000 in face amount of adjustment bonds.

If all the general creditors and all the stockholders should accept the offer, the result would be as follows:

General creditors in the amount of $5,400,000 would acquire for cash sum of $2,025,000	
First Mortgage 5s	$2,700,000
Five-year notes	5,400,000
Stock, shares	27,000
Stockholders in the amount of $20,000,000 par value would acquire for cash sum of $1,500,000	
First Mortgage 5s	$2,000,000
Stock, shares	100,000

Let us now make certain assumptions of happenings on the promulgation of the plan.

Holders of the C D First 6s do not assent to the extent of $500,000 and require cash at 30 cents of	$150,000
Holders of A, B, C & D First and Refunding 5s to the extent of $500,000 do not assent and require cash at 20 cents of	100,000
General creditors to the extent of $500,000 do not assent and require cash at 42.25 cents of	211,250
Total cash requirements for the non-assenting	$461,250

Since this is below the allowance of $575,000 estimated for such claims, the bankers thereupon, for an underwriting commission of 20,000 shares in stock and $50,000 in cash, unconditionally agree to take up at 75 all First Mortgage bonds not taken up by the general creditors and stockholders, and the plan is declared operative.

VOLUNTARY ADJUSTMENTS OF THE CAPITAL ACCOUNT

On the same principles, and for the same reasons, presented in our consideration of the ordinary voluntary composition of the individual debtor, large corporate enterprises have been able to effect voluntary adjustments of the capital account. Owing to the magnitude and complexity of the corporate situations, and especially the large number of people affected, such adjustments are difficult. Only the essential threat of the judicial sale as an alternative makes them possible.

Nevertheless we had in 1907 the noteworthy voluntary adjustment in the case of the Westinghouse Electric and Manufacturing Company. And in the 1921 period voluntary settlements were made to a considerable extent. However, with the available new statutory reorganization described in the next chapter, it seems probable that the larger enterprises will be less likely to attempt to overcome the difficulties of action without judicial proceedings.

CHAPTER XLIV

New Style Reorganizations

Repeatedly the preceding chapters have stated that they present the process of reorganization as it has in the past been carried on under a general creditors' bill in equity; and they have told the reader that we now have recent legislation in an amendment of the National Bankruptcy Act, providing a new reorganization process. They have also said that, unless the courts find the new measures unconstitutional, in the future most reorganizations will, in all probability, be carried through under them.

In their essentially novel aspects, they do away, on the assent of a sufficient majority, with the judicial sale to determine the cash values of claimants, and for paying, to those who do not assent, their values, so liquidated, in cash. Instead, they impose on the non-assenting a compulsion to take a settlement in an amount and form which a sufficient majority of like parties in interest find fair.

As the preceding chapters have also repeated, these recent enactments provide for settlement of the same kinds of situations as have heretofore been settled under the bill in equity and the cognate process of judicial sale in bankruptcy. They confront the same problems. Presumably the process of settlement will continue essentially the same, with some changes in the mechanism, except as modified by doing away with the judicial sale and cash provision for the non-assenting. For obviously, with this exception, the legislative measures derive throughout from the process of reorganization as we have heretofore seen it.

Whatever doubts one may feel about invasions by statute of long understood rights of settlement of contract, the new legislation appears already to have served a most useful purpose in the beginning of a clearance of the wreckage caused by our latest economic debacle. Anything which aids in this labor of necessity has a strong recommendation in the fact of facilitation, if that

be not more than offset by other loss. Doubtless some adjustments in our stock of social concepts must be made to procure the benefits of group economic action.

And the new legislation is not entirely novel. We have some benefit of experience. Operation of corresponding measures under the British Companies Act, and like British Colonial Statutes, has gone on for many years. A possible difference in conditions leading to a difference in results offers the only argument against the value of this experience. Our own National Bankruptcy Act has for some years contained its provision for compulsory compositions. Probably the experience in this does not have much value as not having arisen out of the conditions of large and complicated corporate situations. Before going on, however, with a discussion of our new enactments for reorganization, we will hastily sketch its background.

COMPOSITIONS IN BANKRUPTCY

When developing the idea of a settlement of the affairs of a business unable to meet its obligations, we have already mentioned the voluntary composition. This, as we saw, rests entirely on contract. No creditor can, by its means, be forced to take anything different or less than what he contracted for, payment in cash in full.

However, in the course of time, legislation gave a sanction to the idea that a creditor ought to accept an offer of settlement that a majority of creditors have found fair. By act of Parliament in 1861, England put this idea into effect through legislation; and in 1874 the United States, by amendment to our Bankruptcy Act, took it over from the English Bankruptcy Act of 1869.

Compositions in bankruptcy interest us only as part of the development of the thought of forcing, by operation of the law, variations in an expressed agreement. In order to bring this among the powers of the Federal Government there must be a petition in bankruptcy before the court, and, until an amendment of the act in 1910, also a judicial finding of the fact of bankruptcy. In short, agreements must be performed in accordance with their tenor, or damages paid, as long as they can be performed without doing injustice to others with whom there is also agreement.

On insolvency, injustice will be done if performance by a debtor of his agreement to pay results in an inequality among creditors.

This is an old principle of law. Until modern changes, the equality has been one of cash settlement, unless, by consent, something else were accepted. We do not now modify the principle of equality, but only that of cash settlement.

Since the amendment of 1910, a debtor may make his offer of composition either before or after an adjudication of bankruptcy. Once the offer is properly made, action on it becomes essentially a separate proceeding. If the necessary number of creditors, a majority of those whose claims have been allowed, do not accept it, or if for any other reason the composition fails of confirmation, the whole matter reverts to the regular bankruptcy process under the petition before the court.

Essentially, the process takes over the old Common Law composition, and makes its terms binding on those who do not consent. Though an adjudication of bankruptcy is no longer necessary, the act affords creditors protection against being misled into a settlement for less than their legal claims, by requiring the debtor to file a schedule of his assets and a list of creditors, and to submit to an examination in court or at a creditors meeting, before he can present his offer.

As a means of settling the affairs of an enterprise of large magnitude and complexity, the statutory requirements present difficulties. After the necessary number of creditors has accepted the offer, the debtor must deposit an amount of cash sufficient to cover the costs of the proceeding, and to pay all claimants for whom the law creates a preference. Moreover, under the law as originally enacted, the settlement with creditors must be in money. To be sure, this was interpreted to include promises to pay money, making an ultimate, rather than an immediate, settlement for cash. But it did not permit a settlement with anything but a creditor security. An amendment to the act now provides for distribution of the "consideration" offered in the composition, without any statement that it must be money. This would seem to open the door for settlement with stock. Apparently there is still fear that this was not the intention.

HAS EQUITY POWER TO FORCE A SECURITY SETTLEMENT ON THE NON-ASSENTING?

Some lawyers have asserted a belief that the courts do not need the force of legislation to compel the non-assenting to take the

terms of a settlement which seems fair to a majority of claimants. Those who so profess say the powers of equity are strong enough to do away with the process of a judicial sale, liquidating values into terms of cash, and giving to claimants not assenting to a plan of reorganization their share in actual cash.

One situation especially has given comfort to those proclaiming the powers of equity, as producing the evidence of works to support their faith. In the course of a receivership of the Chicago, Rock Island and Pacific Railway, the proponents of a plan of reorganization procured the deposit, under the plan, of more than ninety-five per cent of creditors' claims, and ninety-nine per cent of the stock. They presented the plan to the court, which found it fair, turned the property back to the corporation, and enjoined all creditors from suing on their claims.[1] The Circuit Court of Appeals sustained this injunction. Since the claimants could not pursue their remedies, they had to take the securities the plan provided for them, if they were to get anything.

We will not go into the controversy over this case, which involves considerations of law the layman is not interested in. It is enough for us to remark that this extension of the powers of equity has been vigorously debated.[2] Though this one case is not at all the entire background of the argument, it presents the decision lending probably the strongest available support to those who contend for the equity power. The reader will note that though it has the authority of a Circuit Court of Appeals, it did not reach the Supreme Court of the United States.

BRITISH LEGISLATION FOR MAKING A PLAN COMPULSORY ON A NON-ASSENTING MINORITY

Great Britain has since 1870 afforded us an example of legislation in aid of the corporate enterprise in financial difficulties, by making reorganization plans compulsory on a non-assenting minority. Under it, the assenting majority must reach three-fourths of each class of claims, a preponderance sufficient to create a strong probability of the fairness of the plan, which, in addition,

[1] *Phipps v. Chicago R. I. & P. Ry.*, 284 Fed. 945, C. C. A. 8th, 1922; *Chicago R. I. & P. Ry. v. Lincoln, etc., Co.*, 284 Fed. 955, C. C. A. 8th, 1927.

[2] J. N. Rosenberg, R. T. Swaine, and R. Walker, *Corporate Reorganization and the Federal Court;* Robert T. Swaine, "Reorganization of Corporations, Certain Developments of the Last Decade," *Columbia Law Review*, Vol. XXVII, No. 8, p. 901.

the court passes on. Like the British legislation for corporate bankruptcies, this measure for reorganization appears in the Companies Act. Many lawyers and business men in the United States have long advocated our adoption of similar legislation.

REORGANIZATION AMENDMENTS OF THE NATIONAL BANKRUPTCY ACT

Wishes of those who have desired that a minority not assenting to a reorganization plan should be under compulsion to take something besides cash in settlement, namely, to take whatever else a majority had agreed to take, finally came to fulfillment. Congress, by statute of March 3, 1933, adding Section 77 to the Bankruptcy Act, provided for the "Reorganization of Railroads Engaged in Interstate Commerce." By act of June 7, 1934, it added Sections 77A and 77B. They provide like legislation for all railroads not included under Section 77, and for every corporation which, if it had chosen to take the bankruptcy path, could become a bankrupt under the act.

REORGANIZATION PETITION BY THE DEBTOR OR BY CREDITORS UNDER THE AMENDED BANKRUPTCY ACT

Just as in bankruptcy, either the debtor or creditors may present a petition initiating the proceeding. On presentation by the debtor, it must show the financial condition of the enterprise and any other facts which indicate the need for a reorganization. Creditors, who must be at least three in number, having aggregate provable claims of $1000, must allege that the corporation is insolvent, or unable to meet its debts as they mature. Unless a proceeding in bankruptcy or equity is pending, a creditor's petition must also allege an act of bankruptcy within four months.

We notice several interesting things about these provisions. First, they call the corporation in financial difficulties the "debtor," and not a "bankrupt," as the bankruptcy sections of the act designate it, whether it has yet been so adjudicated or not. Also on its voluntarily proceeding for reorganization it has to show only facts which disclose that it needs this treatment. For a voluntary petition in bankruptcy, it prays that it may be adjudicated bankrupt.

Under involuntary bankruptcy proceedings, the petitioning creditors must allege that the debtor is insolvent. As the statute

defines the word, insolvency means that the assets of the debtor, at a fair value, are not equal to the amount of its debts. The requirement of an allegation of insolvency in this sense has always presented a stumbling block to creditors seeking to have the debtor's estate taken under the protection of the court, and administered on the principle of equality.

Questions of value present almost insuperable difficulties. A debtor desiring to retain his assets would defend on the ground that it was not insolvent. We observe that for reorganization the creditors do not have to allege that the debtor is insolvent, but may choose the alternative of saying that it is unable to meet its debts as they mature.

What good does it do a creditor that the fair value of the assets of the debtor exceeds its liabilities, if the debtor does not apply the assets to satisfy the claim? Of course, as for the one creditor seeking satisfaction, he has his remedy of judgment and levy of execution. Unless the assets have a liquidation value equal to their fair value, this remedy will result in inequality. At forced sale it is highly improbable, for the ordinary batch of assets, that the liquidation value of an enterprise in distress will equal the claims of all debtors, or will equal a court's finding of fair value.

On a petition by creditors for reorganization of the debtor, though they need not allege insolvency, nevertheless they must allege an act of bankruptcy within four months. Such an act is more susceptible of proof than the fair value of property. For example, a judgment lien, undischarged for thirty days, constitutes an act of bankruptcy. We will not delay to enumerate the entire six acts the statute sets forth.

REORGANIZATION PROCEEDING UNDER THE BANKRUPTCY ACT HAS THE RIGHT OF WAY

Our phrase "unless a proceeding in bankruptcy or equity is pending," as an exception to the requirement that petitioning creditors must allege an act of bankruptcy, calls for comment. Just as we saw that a proceeding in bankruptcy has the right of way over other proceedings already begun for the settlement of affairs, so now we find a petition for reorganization taking precedence over a bankruptcy proceeding already begun, as well as over a bill in equity.

However, if a bankruptcy proceeding has been begun, the re-

organization application becomes a subsidiary to that, going forward while the main proceeding is held in abeyance, to revive on failure of the reorganization application. Here we see a likeness to the composition in bankruptcy; with this difference, that there must be a bankruptcy proceeding, to establish jurisdiction, before the offer of composition. Congress deems reorganization as sufficiently in the nature of bankruptcy to come within the Federal powers.

Priority of proceedings was always something of a bugbear on initiating settlements by a bill in equity. If the corporation was subject to bankruptcy, i.e., was not a railroad or other corporation outside of the act, creditors hostile to the equity process, and desiring to take control of matters away from those who had initiated it, could present a petition in bankruptcy, under which they could draw the situation out of the District Court's equity jurisdiction, and place it on the bankruptcy side. To forestall this, a practice developed under which those who caused the bill in equity to be filed, subsequently also caused a bankruptcy petition to be presented.

After they had begun the bankruptcy proceeding, however, they did not prosecute it to point of adjudication and supplanting the equity bill, but just let it lie. No one else could begin a bankruptcy proceeding while this one was pending. To be sure, an interested party could force the prosecution of the bankruptcy petition. Still, if matters came to that pass, those who had enjoyed the initiative in the equity measure at least retained the advantage of initiative in the bankruptcy proceeding. In later years the Federal courts became averse to entertaining creditors' bills in equity in situations which could be brought into bankruptcy; and perhaps readier to recognize the possibilities of bankruptcy for a reorganization preserving the going concern values.

TRUSTEE TAKES TITLE

We have seen that a receiver under a bill in equity is an agent of the court for the purpose of taking the corporate assets into possession and carrying on the enterprise pending settlement. The line of authority may change on the initiation of foreclosure, when he becomes receiver in that proceeding. In the statutory reorganization, the court appoints a trustee, just as in bankruptcy. Operation of the statute vests him with title to the assets.

NO ANCILLARY PROCEEDINGS

One happy consequence follows, an extension of the District Court's jurisdiction. Since, by operation of the law, the trustee gets the title to all the assets of the enterprise, wherever located, it becomes unnecessary to institute and follow up ancillary proceedings, which we saw are necessary, under a bill in equity, whenever there are assets outside the district of the primary proceeding. This aspect of the statutory process should effect a great simplification of the work of settlement.

EXECUTORY CONTRACTS AND LEASES

Injustices under a bill in equity in dealing with strictly lease covenants, in case the receiver does not adopt them, disappear under the statutory provisions. As in bankruptcy, they establish a rule, and for reorganizations provide that the lessor may claim for an amount not exceeding three years rent, plus rent already accrued. Other executory contracts presumably will be liquidated as heretofore.

PLAN OF REORGANIZATION

The debtor may file a plan of reorganization in the proceeding. A creditor or a stockholder may file a plan after first obtaining approval of it by creditors, whose claims the plan would affect, holding twenty-five per cent of the amount of any class of claims and ten per cent of the total of all claims.

If the debtor has not been found insolvent, in the bankruptcy sense of a value of assets less than liabilities, the approval of stockholders aggregating ten per cent in amount of any class, and ten per cent of the total outstanding shares of all classes, is sufficient.

Readers will keep in mind that these requirements have nothing to do with the plan's coming into operation, but are prerequisites for presenting it in the proceeding.

WHEN THE PLAN IS ENFORCEABLE ON NON-ASSENTING SECURITY HOLDERS OF CLASSES AFFECTED

Here we come to the core of the statute. It has for its chief purpose the avoidance of the expenses and difficulties of judicial

sale, and the overcoming of the burden of making the cash provision for those not assenting, when a sufficient majority, by assenting to the plan, express their belief in its fairness. If the plan does not affect a class of creditors or stockholders adversely, but leaves them essentially in the position they hold, their assent is not necessary.

IN THE CASE OF CREDITORS

The plan becomes compulsory on a creditor, who must accept its provisions, and must take what it provides for him, on the fulfillment of the following conditions:

(1) If two-thirds of his class have consented to it.
(2) If it does not affect the class to which he belongs.

The situation in this second division hardly needs to be expressed. Still, for the sake of completeness and clarity it is well that the act states it. In a reorganization carried out by foreclosure instituted as a subsidiary proceeding under a bill in equity, bondholders secured by a prior mortgage have no standing to object. They still have all the rights they ever had.

IN THE CASE OF STOCKHOLDERS

Stockholders are bound by the plan on the fulfillment of any one of the following conditions:

(1) If the holders of a majority of shares of the class they hold have accepted it, whereupon the non-assenting must take the provision it makes for them.
(2) If the plan does not affect the class to which they belong.
(3) If the judge shall have determined that the debtor is insolvent.
(4) If the plan provides for a realization by the stockholder of the value of his equity.

On a finding by a judge that the liabilities of the corporation exceed its assets, we see that stockholder consent becomes unnecessary. This judicial finding of insolvency presents an aspect of interest. A judicial sale establishes the liquidation value. It is hardly within the bounds of imagination that there would be any surplus for stockholders on the sale. Yet, if the sale should by any chance establish that the owners had an equity, the sur-

plus would be returned to them. The statutory reorganization process cuts off the equity by determination of value through other means than a sale.

CREDITORS FOR WHOM THE PROVISIONS OF THE PLAN ARE NOT COMPULSORY

Proponents of a plan must provide in it their choice among any of the following methods of satisfying those creditors on whom the provision of the plan for their class is not compulsory:

(1) The plan may give the creditor the same interest in the property he already has. This amounts to putting him in a class of those whose interests are not affected.

(2) The plan may ask the court to fix an upset price and cause the property to be brought to sale. This amounts to putting the non-assenting creditor in the position he would be in if the reorganization were carried through by judicial sale in the manner described in the preceding chapters, and for that purpose makes it unnecessary to start all over again with a new proceeding.

(3) The plan may ask for an appraisal of the value of the non-assenting creditor's interest, and provide that cash shall be paid at the valuation found. If, however, the plan provides this method, the creditor may instead elect to take the securities which the plan provides for those assenting. One would think that this election might also have been provided in case of a reorganization sale on the second method.

Such an appraisal is the familiar means, which many corporation statutes provide, for satisfying stockholders who are not content with the security terms of a merger or consolidation. We have simply its transference to the creditor situation, so that the creditor must accept an appraisal instead of a sale liquidation of his value.

CORRESPONDING PROVISIONS FOR REALIZATION BY STOCKHOLDER OF THE VALUE OF HIS EQUITY

Among the conditions on which the plan would become compulsory on stockholders was (4) if it provides for a realization by them of the value of their equity. The provision is to be made in the same way as for non-assenting creditors, except that the method of fixing an upset price and sale does not apply.

PROBABLE EFFECT OF FAILURE TO GET ASSENTS NECESSARY TO MAKE PLAN COMPULSORY ON ALL

However desirable the presentation of these means of dealing with the non-assenting, one may venture a surmise that they will not often be called into actual use. Except for one, that the dissenting creditor retain his interest, they require the provision of cash, the stumbling block of the older forms of reorganization. If cash must be provided for more than a third of any considerable class of claimants, the situation is likely to become prohibitive.

On the other hand, if those formulating the plan present the method of the dissentient retaining his interest, it seems probable that all will want to do what is impossible for all, retain their interests, and the plan will not obtain sufficient assents to effect the necessary reduction in claims. Even if the situation is the general creditor one, in which suppliers of material are willing to make present sacrifices for the sake of retaining a customer, they may well regard the payment in full of more than a third of corresponding claims as too great a sacrifice.

REGULATORY BODIES

We are not now considering the reorganization of interstate railroads under Section 77. With respect to intrastate railroads and public utility corporations, which come under Section 77B, the act makes the following requirements:

(1) If the enterprise is wholly intrastate, the plan must be submitted to the public utility commission or other authority having jurisdiction. Then the commission may certify to the court that the plan affects the public interest. On such certification the court will not approve the plan unless the regulatory authority approves it. If the commission does not so certify within the statutory period, the court shall deem that the public interest is not affected.

(2) For an interstate public utility, the plan must be submitted to the regulatory authorities of every State having jurisdiction, and they must be given an opportunity to submit amendments or objections, on which the judge must hold a hearing.

(3) In connection with the relationship of the proceedings with regulatory bodies, the judge shall confirm the plan only if satisfied

that all authorizations, approvals, or consents of each commission or authority, of a State in which property of the debtor is operated, have been obtained.

One infers that, in the case of the intrastate enterprise, when the commission fails to file a certificate of public interest, the arising of the presumption that it is not affected, and, in case of interstate enterprises, the opportunity to present suggestions and objections and be heard, are merely conditions on which the proceeding may go on towards a conclusion; but that the proponents of the reorganization must, in the end, present the consents of all regulatory bodies before the court will confirm the plan.

PROTECTIVE COMMITTEES AND DEPOSIT AGREEMENTS

Need for formulating the groups of the classes of interests for protection in the reorganization process does not disappear with the new legislation. Someone must still take the initiative. Assuming the simplest situation, that the corporation presents the petition, we must still have a plan; and, if the plan is to become effective, it must have a sufficient number consenting to it. Interests of classes of claimants are adverse. We have all the problems of the terms of reorganization, except, when the necessary number of assents are given, the very important one of cash provision for the non-assenting. So we will have committees and deposit agreements as before. The new legislation, however, contains some provisions that will be helpful.

It requires the judge to scrutinize deposit agreements, trust indentures, committee or other authorizations, and purports to authorize him to disregard any limitations or provisions in them. This last is rather a deep invasion of contract, and arouses some wonder as to how far it may go.

Probably the statutory clauses aim at "trick" terms in these agreements, which are sometimes complained of, and properly. Trust indentures, and even deposit agreements, are lengthy instruments. They are not altogether fascinating for laymen, who, indeed, if they read them, could not understand the significance of some of the paragraphs. Security holders get the indenture only on special application. A little while after the marketing of an issue, the investor cannot ordinarily obtain a copy of the document at all, and can see it only by the courtesy of the trustee.

For the most part the only paper the security holder ordinarily gets in the case of a bond is a copy of the prospectus. Often a copy of a deposit agreement is sent him, but it is long, and he does not scrutinize it closely. One may say that he ought to read it with care. But we deal with human frailty. If an investor in a considerable number of issues read carefully every instrument affecting him, he would have little time to acquire the means of further investing.

None too scrupulous draftsmen, serving the purposes of none too scrupulous clients, have sometimes written in unusual provisions substantially affecting the interests of the investor. Those concerned in the first instance would have no cause to complain if such clauses and their effect were clearly called to their attention. One surmises that sometimes those who put them in venture to do so in the knowledge that they will escape attention until needed. Besides, the first taker does not always retain the security. It is current in the market, and is bought and sold with little regard for the indenture or deposit agreement, which are assumed to be in the ordinary form.

One assumes that the court will not go beyond disregarding terms of indentures and deposit agreements that are inequitable. The fact that an enterprise is in need of reorganization ought not to be a means of abolishing rights of contract. Otherwise the Congressional foot measuring justice becomes considerably more elongated than the proverbial foot of any Chancellor. To be sure, the Constitution, which expressly restrains the States from impairing obligations of contract, does not so restrain the Federal Government. But it may be that Congress is purporting to legislate here in a field which is not within the Federal province. A little later in the act a phrase indicates the presumptive intent. It expresses an authority in the judge to restrain the exercise of any power which he finds unfair or not consistent with public policy.

The act expressly authorizes the judge to allow reasonable compensation to depositaries, committees, and reorganization managers.

EXPENSES OF REORGANIZATION

Various clauses of Section 77B authorize the payment, out of the corporate estate, of the expenses of reorganization, counsel fees, etc. They also contain a requirement that the judge shall

confirm the plan only after he is satisfied that "all amounts to be paid by the debtor or any corporation or corporations acquiring the debtor's assets, and all amounts to be paid to committees or reorganization managers, whether or not by the debtor or any such corporation for services or expenses incident to such reorganization, have been fully disclosed and are reasonable, or are to be subject to the approval of the judge."

Question arises as to whether a court, without the aid of legislation, has the power to affect contractual arrangements for compensation not to be made out of the fund before the court. That fund is under the jurisdiction of the court, and it can determine how much it may be diminished by the allowance of expenses and fees. If the corporation organized to acquire the assets, or the security holders assenting to the plan, enter into an agreement to pay either all the compensation or an additional amount, is the agreement necessarily before the court?

Costs of reorganization in the past have met with sharp criticism. Though the layman, unfamiliar with the enormous amounts of labor and substantial disbursements necessarily involved, probably has no awareness of how large these costs ought to be, they have seemed often unnecessarily high to men with some competency to estimate their propriety. It is to be hoped that the simplification of the work under the new enactments will result in a reduction of expense. In any event, people performing the labor ought not to object to the court's passing on their total compensation. Courts have often in the past seemed not parsimonious in their estimates of the value of such toil. Still, the fact that compensation must come before a judge for review may tend to reduce the estimate which those who are to receive it place upon the value of their services. At least there will be someone before whom they can be astounded at their moderation.

It may be that the provision for disclosure of total compensation from all sources, and judicial review, was suggested by an instance in the Chicago, Milwaukee and St. Paul reorganization. A separate contract with security holders stipulated for compensation. The Interstate Commerce Commission sought to supervise the expense. The Supreme Court held that the Commission had no authority.[1] Anything further in the case would seem to be dictum. Whether or not the requirements of Section 77B with respect to expenses will stick, remains to be seen.

[1] 282 U. S. 311 (1931).

TRUSTEE'S CERTIFICATES

Following the tenor of reorganization situations, the enterprise may be in need of such credit as receiver's certificates supply. For this purpose the act expressly confers power on the judge, who "may for cause shown, authorize the debtor or the trustee or trustees if appointed, to issue certificates for cash, property or other consideration approved by the judge for such lawful purposes, and upon such terms and conditions and with such security and such priority in payments over existing obligations, secured or unsecured, as may be lawful in the particular case."

FEDERAL SECURITIES ACT

One provision of Section 77B is:

All securities issued pursuant to any plan of reorganization confirmed by the court in accordance with the provisions of this section, including, without limiting the generality of the foregoing, any securities issued pursuant to such plan for the purpose of raising money for working capital and other purposes of such plan and securities issued by the debtor or by the trustee or trustees pursuant to subdivision (c), clause (3), of this section, and all certificates of deposit representing securities of or claims against the debtor which it is proposed to deal with under any such plan, shall be exempt from the Securities Act of 1933, approved May 27, 1933, except the provisions of subdivision (2) of section 12, and section 17 thereof as applied to any willful violation of said section 17.

The reference to securities issued by the debtor or by the trustee or trustees pursuant to subdivision (c), clause (3), relates to trustee's certificates (the equivalent of receiver's certificates) referred to under the preceding topic.

On turning to the excepted provisions of subdivision 2 of Section 12 of the Securities Act of 1933, one finds that it reads: "Any person who * * * sells a security (whether or not exempted by the provisions of section 3, other than paragraph (2) of subsection (a) thereof), by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact," etc., "shall be liable," etc.

The Securities Act of 1933, in Section 3 (10), exempts:

Any security which is issued in exchange for one or more bona fide outstanding securities, claims or property interests, or partly in such

exchange and partly for cash, where the terms and conditions of such issuance and exchange are approved, after a hearing upon the fairness of such terms and conditions at which all persons to whom it is proposed to issue securities in such exchange shall have the right to appear, by any court or by any official or agency of the United States, or by any State or Territorial banking or insurance commission or other governmental authority expressly authorized by law to grant such approval.

A discrepancy appears between the exempting provisions of Section 77B and those of the Security Act of 1933. The latter provides only for *exchanges* of securities. Its provisions for exchanges involving cash payments seem sufficiently to cover new capital requirements to the extent that such capital is obtained from the old security holders. But they do not expressly include securities provided in the plan for direct sale for cash. The clause in Section 77B reads much more broadly. Its exemption purports to include "any securities issued pursuant to such plan for the purpose of raising money for working capital and other purposes of such plan."

The upshot of the matter seems to be that securities issued in exchange with the holders of old securities are in the clear. It may be remarked that if the plan of reorganization provides for securities to be issued to the general investing public, these prospective investors do not have the right to appear in court hearings on the plan. Still, "all persons to whom it is proposed to issue securities in such exchange" do have the right to appear. So presumably the fact that the plan may provide general investor securities would not destroy the exemption as to securities to be issued in exchange. But does the broader clause of Section 77B extend the exemption to general investor securities? One surmises that it would be dangerous to assume that the provisions of the Securities Act of 1933 do not limit the application of the seemingly broader clause of Section 77B.

UNDERWRITING THE PLAN

Though the statutory process makes it possible to reorganize without the necessity of providing cash for the non-assenting, it does not do away with the need for other cash provision. As heretofore, plans will have to provide securities to raise the cash, and will have to be underwritten to assure that it will be forthcoming. Underwriters, however, will not have to wait for the

problems. We are simply making no attempt here to consider them. However, there seems to be a general acquiescence in the measures. Inclusion of the sections in the Bankruptcy Act indicates that their sponsors rely on the general powers of Congress to legislate in this field.

INTERSTATE RAILROADS

In our discussion of statutory reorganizations, we have considered the measures out of their chronological order, because Section 77B covers a wide range of corporations, including as it does the whole variety of industrial and public utility enterprises. Certain aspects of railroad finance make it a somewhat special subject. Particularly this arises out of the fairly long established jurisdiction of the Interstate Commerce Commission with its control over the issuance of railroad securities. When Congress enacted Section 77 of the National Bankruptcy Act, providing for the reorganization of interstate railroads, it was careful to do nothing to disturb the Commission's control. The extent to which it supervises a statutory reorganization marks the chief difference between Sections 77 and 77B.

PETITION

As for other enterprises, the railroad corporation may itself be the petitioner. When it presents its petition to the court, it must at the same time file a copy of the petition with the Commission.

Creditors having claims aggregating five per cent or more of all indebtedness may petition, after a hearing by the Commission and its approval of the proposed presentation of the petition to the court.

TRUSTEES

The Commission is to prepare a list of persons whom it approves for acting as trustees in a railroad reorganization, and the court is to designate the trustee from these approved names.

PRIORITIES

All the priorities established in the creditors' bill proceeding are statutorily preserved. The reader will recall the discussion in the preceding chapters of the *Fosdick v. Schall* or six months rule.

PLAN

Control by the Commission of the development of the plan of reorganization presents a substantial variation from the process under Section 77B. All the proposed plans are to be presented first to the Commission. The corporation itself is to present one. A trustee may do so. Creditors holding not less than ten per cent of any class of obligations may also present a plan. The Commission may prepare a plan of its own. It is to hold hearings on the various proposals, and finally recommend one or more plans for submission to the security holders.

The act provides that:

> A plan of reorganization shall not be finally approved by the commission until it has been accepted in writing and such acceptance has been filed in the proceeding by or on behalf of creditors holding two-thirds of amount of the claims of each class whose claims or interests would be affected by the plan, and by or on behalf of stockholders of the debtor holding two-thirds of the stock of each class: Provided, however, That if adequate provision is made in the plan for the protection of the interests, claims, and liens of any class of creditors or stockholders in the manner provided in clauses (5) and (6) of subdivision (g), of this section, then the acceptance of the plan by such class of creditor or stockholders shall not be requisite to the approval of the plan.

Provision for the non-assenting follows the lines already presented for Section 77B.

GOVERNMENT REGULATION OF SALE OF SECURITIES

Since the Interstate Commerce Commission has jurisdiction over the issuance of the securities of railroads engaged in interstate commerce, the Securities Act of 1933 exempts such securities from its provisions.

STATE STATUTORY REORGANIZATION

New York, at least, among the States, has enacted a reorganization statute making compulsory on a minority the provisions of a plan approved by the holders of two-thirds of the certificates of participation secured by mortgage on real property.[1]

[1] New York, Laws of 1933, Ch. 729, in effect May 3, 1933; Real Property Law, Sections 119–123 inclusive.

Mortgage guarantee companies organized under the insurance law, and other real estate bond concerns, had sold, in the aggregate, large amounts of certificates. When defaults became frequent, the capital stock of the guarantee companies was not adequate to protect the security holders for more than a short time. The Superintendent of Insurance took possession of most of these concerns, essentially as a receiver. Therefore they were not in the position of an investment banker to take the initiative on default. So the mortgage certificate situation fell into a chaotic condition. Some companies which had sold mortgage certificates without guarantee failed to cope adequately with defaults in mortgage securities they had sold.

One has the impression not only of inexperience of the real estate people in handling these group loans in difficulties, but also that the ethics in some cases were not as good as those of investment banking houses in the general corporation field. Partly through the utilization of the reorganization statute, and the assistance of a special division of the Supreme Court, progress is being made in the clearance of this real estate wreckage.

CONCLUSION

No endeavor at completeness has been made in the foregoing summary of the new legislation. Only enough has been attempted to give one who is not a lawyer, but has read the preceding chapters, an idea of the essential statutory changes in the reorganization process.

One may feel hopeful that such statutory reorganization may be found constitutional in its substantial tenor, and will work well in practice. For the successful functioning of group financing of enterprise probably some modifications must be made of principles developed in the dealings of the individual creditor directly with the individual debtor. Writing of Section 77B, Joseph L. Weiner states the sapient caution: [1]

> It is probable, also, that the chief beneficiaries of the act will be the stockholders and the management. Armed with the power to withhold payment on outstanding bonds and debentures, and to promise to resume partial or even full payment upon the consummation of a reorganization plan, the debtor is in a position to solicit acceptances effectively before

[1] Joseph L. Weiner, "Corporate Reorganization: Section 77B of the Bankruptcy Act," *Columbia Law Review*, November, 1934, Vol. XXXIV, p. 1173.

any proceeding is commenced and without disclosures which would aid an opposition group. In order to carry out a reorganization without the assent of stockholders, it will be necessary to determine that the corporation is insolvent (in the bankruptcy sense) — an expensive and difficult undertaking. Even then the stockholders cannot be ignored, if it is desired to retain the old corporation and avoid the expense of reincorporation. Moreover, the debtor is in a favored position in the conduct of the proceedings since it alone has the right to be heard on all questions and may propose a reorganization plan without first securing its acceptance by a substantial percentage of the security holders. All these considerations reinforce the conclusion that the major effect of the statute will be to make reorganization plans turn upon the question of what sacrifices stockholders can induce creditors to make in order to accomplish a prompt reorganization.

By the same token, the position of the management is considerably strengthened. The management may be continued in charge of the company without even the intervention of a trustee. Even where trustees are appointed, one of the trustees will, in all likelihood, be a former officer. The operating organization is accustomed to the existing management and a considerable time would be required to build up new loyalties, more time than is likely to elapse between the commencement of the proceedings and the confirmation of the plan.[1]

[1] Philip N. Payne, *Plans of Corporate Reorganization*, The Foundation Press, Inc., Chicago, 1934, contains the reorganization amendments, some discussion of them, and a selection of forms that have been used.

Ninth Section

Capital for Corporations

CHAPTER XLV

Trust Companies and Corporation Finance

Various chapters throughout the text have discussed the part taken by a trust company in particular transactions. It seems appropriate now, however, to bring these scattered matters all together in a consideration of the position of the trust companies themselves in corporation finance. They have become an essential part of group functioning.

TRUST COMPANY ADVANTAGE

A corporate trustee has certain rather obvious advantages as a means for enabling a group loan to be made with the single security for the equal pro rata benefit of the members of the lending group, as in the typical case of a bond issue secured by a mortgage on the corporate property. The mortgagor corporation, a continuing group, borrows on long term credit. An individual trustee may die, or become incapacitated, before the completion of the trust.

SUCCESSOR TRUSTEE

Of course the trust indenture may provide a means for the appointment of a successor trustee and usually does, even in the case of an original corporate trustee. Such a provision would facilitate handling matters on the death of an original individual trustee. Still the original appointment of a corporate trustee, the trust company, reduces the probability that the trouble of the appointment of a successor will have to be gone through. During a period of bank consolidations, to be sure, the identity of the original trustee may merge into another trust company. But the trust indenture can provide that the merging or successor trust company shall continue the trust.

ONE TRUST COMPANY DISADVANTAGE

A corporate trustee suffers one disability in comparison with an individual, who can hold title to property and do business anywhere in the United States. If the terms of the trust involve the trustee in doing business outside the State of its incorporation, it must have qualified as a foreign corporation in the other State or States. Though an individual may be disqualified as an alien from holding property in another country, it is seldom that a trust involves business in more than one national jurisdiction. However, the advantages of the trust company have far outweighed the disadvantages, and the appointment of a trust company trustee has become the regular practice.

ECONOMY OF DIVISION OF LABOR

Uses of the trust company, other than serving as trustee, in the financial affairs of the corporations arise out of the economy of division of labor. Many financial transactions are not frequently repeated. The corporation does not bring out a bond issue or issue additional stock every day. It cannot employ men for the purpose of attending exclusively to these matters, which require special experience. And even for transfers of stock, which are frequent, only the largest active market issues would occupy the time of a staff especially for transfers of the one issue.

CORPORATE TRUST DEPARTMENTS

Trust companies in the larger cities have so much of the various types of corporate work to do that they maintain corporation trust departments staffed with executives of special experience and a clerical force trained in the particular work. Only the very largest corporations could afford such a personnel, and even large corporations generally find it expedient to employ the trust company. The corporate trust department handles the work of the trust company in acting as:

Trustee under trust indentures
Stock transfer agents
Registrars of stock
Depositaries under protective committee agreements and reorganization plans

Fiscal agents in the payment of dividends and interest
Custodian of securities

Though this last function of custodian of securities is not a part of the financial business of issuing corporations, but relates to the affairs of investors, it seems appropriate to consider it here as in the field of securities. Moreover the functions of custodian are likely to be placed in the trust company's department for individual rather than corporate trusts.

TRUSTEE UNDER TRUST INDENTURES

Under corporate trust indentures the function of the trustee involves more than a mere naked trust of being vested with the title to property. Those who are unfamiliar with the work involved sometimes think that once the indenture is executed and delivered the trustee has nothing further to do, unless the corporation gets into difficulties, when the trust company must formally act for the application of the security to the satisfaction of the debt. On the contrary, however much the elaborate provisions of the indenture appear to pare down the responsibility of the trustee, it remains charged with much that involves duty and labor.

VALIDITY OF THE TRUST

In assuming the responsibility, the trust company needs to be satisfied that the trust is validly constituted and actually confers the purported authority. Counsel to the bankers and counsel to the corporation do the work, but counsel to the trust company passes on it from the trustee's viewpoint, and sees to it not only that the trust is valid, but that its provisions are such that the duties it imposes on the trustee can be carried out, i.e., that it is a workable instrument.

Records of the trustee should be adequate as evidence of validity of the trust. To this end the trust officer will require:

(1) A copy, certified by the Secretary of State, of the certificate of incorporation of the issuer, and all amendments.

(2) A copy, certified by the secretary of the corporation, of the by-laws.

(3) Copies, certified by the secretary of the corporation, of the minutes of the meetings of directors and stockholders, which

authorized mortgaging the property, executing the mortgage, and issuing the bonds.

(4) A copy, certified by the secretary of the corporation, of the form of mortgage submitted to the meetings of stockholders and directors.

(5) Opinion of counsel to the corporation that the mortgage and the bonds to be issued thereunder have been duly authorized by proper corporate action, and that the mortgage when executed and delivered will give the lien it purports to create, and will be a legal and binding obligation of the corporation in all its terms, and that the bonds when executed, authenticated, and delivered will be valid, binding, and legal obligations of the corporation.

(6) Opinion by counsel to the bankers on the validity of the issue.

(7) Certificate, by the secretary and another officer, of the election of the officers executing the indenture and the bonds, that they are now holding the designated offices, and that the specimen signatures presented are the signatures of these officers.

(8) Any other papers that may be necessary, by reason of the law of any particular jurisdiction, to establish validity.

On the execution and delivery of the indenture, counsel to the trust company will add his opinion as to the validity of the trust and the issue of bonds thereunder.

At the closing the trust officer will see that the proper amount of revenue stamps is attached to the indenture to cover the Federal tax on the amount of bonds to be issued.

Executed counterparts of the mortgage will be delivered to counsel for the bankers for recording. The trust officer must see that all these are redelivered for his files with endorsements of recording and the counsel's opinion that they have been recorded in all places required and evidence that all recording fees and taxes have been paid.

AUTHENTICATION AND DELIVERY OF BONDS

The trust officer will require an order from the corporation for the authentication and delivery of the amount of bonds to be presently delivered in accordance with the terms of the indenture. If the issue is listed on the stock exchange, he will inform the exchange of the execution and delivery of the bonds.

When temporary bonds are issued, the trust company will have to authenticate the definitive bonds and carry through the exchange for those in the temporary form. It will notify the stock exchange of readiness to exchange.

Since an issue of $20,000,000 of coupon bonds of the denomination of $1000 includes 20,000 pieces of paper, the amount of work involved in just the authentication is apparent.

CONTINUING SERVICE OF THE TRUSTEE

A mortgage made to a trustee requires all the current care of any mortgage. The trust company must have a schedule of all taxes payable that may become a lien on the mortgage premises, and require the corporation to exhibit receipts evidencing payment. The indenture, just as an individual mortgage, makes failure to pay taxes an event of default, and it is the duty of the trustee, acting for the lending group, to see that its security does not become endangered by tax liens. Further, the trust indenture contains provisions, sometimes elaborate, as to the amount of insurance to be carried. It is the duty of the trustee to see that it has in its possession policies in force providing the required protection.

States may require that chattel mortgages, to remain effective as against purchasers without notice, must be filed anew at fairly frequent periods. So if the indenture includes a mortgage on chattels, as is likely to be the case in a corporation mortgage, the trustee must see that there is a proper periodical refiling.

The trustee may have to attend to the redemption of bonds for the sinking fund or otherwise. If the redemption is made through drawing by lot, the 20,000 pieces of a $20,000,000 bond issue involve entering each serial number on a separate card, putting the cards in a receptacle for the lottery, tabulating the drawn numbers, and preparing and inserting an advertisement of the bonds called for redemption. Existence of registered bonds (which have serial numbers reserved for interchangeability in the coupon form) adds, as a complication to the matter, the necessity of issuing new bonds for the uncalled registered amounts.

At the semi-annual interest dates the trustee will disburse to coupon and registered bondholders the interest payments made by the corporation. In due course the trustee will burn the surrendered coupons and make its incineration certificate. Corre-

spondingly, on receiving from the corporation at maturity of the bonds the principal sum due, the trustee, on receiving surrender of the bonds, will make payment. Correspondingly it will burn the bonds and issue its incineration certificate. The certificates preserve in the record of the trust the evidence of surrender and destruction of the paper evidencing the debt. If not all the paper is surrendered for payment, the mortgage provides that, on payment of the funds to an account for those bondholders who have not so presented their bonds and coupons, all claim of such holders against the corporation is discharged, and they may look only to the fund set up for them. When all claims against the corporation are satisfied, either by surrender of bonds and coupons, or under the special provision of substitution of the fund for payment, the trustee must discharge the mortgage.

SERVICE ON DEFAULT

When an obligor pays its bond issue in accordance with the promise, on time and in full, the story has a happy ending. But a story of finance often does not end happily. And on a default the trust company trustee enters actively into the situation. Mortgages securing bond issues contain the provisions which enable the lending group to function. An individual owning himself an entire mortgage exercises his discretion, to start foreclosure or not, on the default of the mortgagor. In the case of the group lender, what shall determine the course of action? The group does not in the indenture instruct the trustee that it must start foreclosure immediately on the happening of an event of default. By the indenture the group authorizes the trustee to take action; the trustee "may" do so and so. But a trustee does not ordinarily act under this authorization. The indenture provides, however, that the trustee must act when the stated percentage of bondholders instruct it to do so, and indemnify it against loss in so acting. However, it is usually so desirable that steps be taken to appropriate the security to the satisfaction of the debt that usually much less than a majority of the bondholders are given the right to demand that the trustee take action. Indentures frequently provide that twenty-five per cent may require the trustee to proceed. In the chapters on reorganization we have already considered the course of action. We have seen also that although the indenture provides that the trustee must proceed on

the demand of the stated number of bondholders, nevertheless on the appointment of a receiver the trustee regularly finds itself confronted with an injunction against such action. With the new Sections 77 and 77B of the Bankruptcy Act now available for reorganizations, it seems unlikely that in the future the trustee will actually foreclose. The mortgage becomes merely a measure of the bondholders' values for the purpose of a reorganization settlement.

TRANSFER AGENTS AND REGISTRARS

Though a corporation may maintain its own office for the transfer of its shares, it cannot perform the function of a registrar. The very purpose of a registrar is to serve as an auditor of the issuance and transfer. Since the corporation, through either its own officers or employees, or its designated agency, issues and transfers its own stock, the very idea of an auditor of these acts involves an independent agency. Therefore the corporation must go outside of itself to have the duties of a registrar performed, and it naturally designates a trust company as registrar of its stock.

In nearly all small corporations, with few stockholders and infrequent changes in ownership, the officers attend to the issuance and transfers of stock. Such corporations have no registrar. If, at the time of organizing, a corporation finds it necessary to have a transfer agent, or otherwise deems a transfer agent desirable, the directors would do well to adopt at their first meeting a resolution designating the transfer agent (and registrar, if there is to be one) and to turn over to the transfer agent the work of issuing the stock. Then the agent has in his hands from the start the making of the records from the transactions and the responsibility for their being accurate. The matter requires the utmost care, and people who have other duties to perform are more likely to make mistakes in their record than the corporation department of a trust company with employees especially trained for the duty of keeping stock lists and having it as their only responsibility.

We have under the heading of "Course of a Transfer" in Chapter XXV already sufficiently described the work of trust companies in acting as transfer agents and registrars of transfers. The facility with which the task is performed and the stock list kept up to the minute presents an achievement in the operation

of business. A journal entry of the transaction is made on loose leaf records in the desired number of copies, subsequently bound in a permanent record; and ledger entries are made from the journal memoranda. There may be transfer agents in more than one city, and the statutory office of the corporation, which under the law must have the list of stockholders, may be in still another city. Every day each transfer agency sends a copy of its journal entries for the day to the other agencies and to the statutory office.

At the same time the principal transfer agent makes for the addressing machine a stencil of the name and address of any new stockholder. For any communication to stockholders, as in sending out notices of meetings or on any other occasion, all the corporation need do is to furnish the communication to the transfer agent and it can attend to the mailing.

FISCAL AGENT

Since the transfer agent keeps the stock list, it is convenient to appoint the trust company so acting fiscal agent for the payment of dividends. Then the corporation on the declaration of a dividend need draw only one check for the aggregate amount and turn it over to the trust company to make out the multitudinous individual checks for stockholders of record on the record day established by the dividend resolution, and mail them out on the resolution payment day.

Correspondingly a trust company trustee under an indenture securing a bond issue acts, as has already been indicated, as fiscal agent for the payment of coupons (and sending checks to registered bondholders), and for the payment of principal at maturity, or on bonds called for redemption. There is a reason for this even more cogent than the reason for having the transfer agent act in the disbursement of dividends. In the case of the secured debt it is highly important that the trustee should know that all claims of bondholders have been paid, and that there are no outstanding bonds or coupons which can turn up in the hands of purchasers for value without notice of prior payment. For until all possible claims are satisfied the trustee is not free to release the property it holds as security for the debt. The best assurance it can get is to have the handling of all payments, and the original receipt and cancellation of paid coupons and bonds.

DEPOSITARIES

In our discussion of reorganizations we considered the steps of the formation of protective committees, the preparation of deposit agreements, the deposit of securities under the agreement authorizing the committee to represent the security holders, and the issuance of certificates for the deposited securities. Naturally a trust company is selected to act as depositary, and, on the deposit of securities, issues its certificate therefor. We have seen that these certificates may be listed on the stock exchange and actively dealt in. So the trust company may have a busy job of making transfers. If the plan of reorganization is not presented, or on promulgation does not go into effect, the depositary will have to deliver the deposited securities to those holding the certificates therefor. Of course the depositary will require the surrender of the certificates and payment of any sum to be charged under the agreement to cover the expense of the committee, including the charge of the trust company for its services. If the plan of reorganization becomes effective, however, ordinarily this expense is allowed by the court out of the corporate fund. Correspondingly, on the promulgation of a plan of reorganization, those who do not assent withdraw their securities. If, after promulgation, the plan goes into effect, the securities left on deposit are turned over to the trust company having charge of the exchange of securities under the plan.

EXCHANGE OF SECURITIES UNDER PLAN OF REORGANIZATION

As just indicated, under a plan of reorganization the exchange of new securities for the old, pursuant to the plan, takes place through a trust company, which receives the securities left on deposit as assenting to the plan and the securities of the corporation issued pursuant to the plan, and carries through the exchange.

CUSTODY ACCOUNTS

Custody accounts come under the individual rather than the corporate trusts department of a trust company. The topic is not strictly a part of the subject of corporation finance. Neither are the secondary markets in securities. Yet these markets have

such a close relationship with the issuance and sale of the securities that at least some discussion of them is necessary. So, too, a security holder's work in caring for the safe possession of his stocks and bonds and collecting the income is really a topic in the subject of investment. Yet in considering the work of trust companies in connection with corporate securities, it seems appropriate to present the work of the division having charge of custody accounts.

No experienced person keeps the paper evidences of investments, bonds or stock certificates, in a tin box in the house or office. Even for unendorsed stock certificates or registered bonds the risks of fire and theft are too great. We have already seen the process of giving a bond to procure the issuance of a new certificate in the event of such loss. And for a coupon bond or endorsed certificate the loss may be absolute. So the investor keeps these papers in a safe deposit company box. For coupon bonds this means a visit to the box on every interest date, and to procure the security for delivery on sale. When absent from the city, the investor must let his interest go uncollected, and cannot sell for delivery in the regular course.

Trust companies offer a service which obviates this difficulty. They will take possession of the securities, collect the income therefrom and deposit it to the owner's account, and will make deliveries on the owner's instructions, which he can give by letter. The trust company keeps an eye out for calls for redemption, and, if any of the deposited securities are called, notifies the owner, who can then instruct delivery for collection. The trust company, making it a special duty to watch for redemption calls, is more likely to see them than the investor; and the service of the custodian may well save the owner the loss of six months interest on the sum to be paid in redemption. In the course of collecting interest the custodian does all the work of making out tax certificates to obtain the benefits of tax covenant bonds. If the investments include real estate mortgages, the custodian keeps track of the insurance and periodically searches the records for the payment of taxes. So, for an annual charge, which is very moderate for the work performed, the investor has the benefit of the services of a staff of trained men in the ordinary keeping of his securities.

Since the securities are not part of the assets of the trust company, their safety should not be affected by its solvency or in-

solvency. The company would be responsible for loss resulting from its negligence. The one risk that the owner runs is the embezzlement of an officer or employee who might succeed in obtaining possession and converting the securities, perhaps to bolster up a failing bank. On the institution becoming insolvent and unable to make good, out of its assets augmented by its insurance against defalcation, the owner would lose. The writer does not know of any such instance. But in this very human and hazardous world he expects sooner or later to hear of one. Whatever risk there is seems a very reasonable one to take with an institution to which one would entrust one's bank account with the much greater risk of insolvency not resulting from defalcation as well as the risk of defalcation.

In New York, at least, it is possible for a fiduciary to utilize a custody account with a trust company for his trust funds and effect a saving in the administration expense of the trust estate. Under the Civil Practice Act he may apply to the court for leave to reduce the amount of his surety bond on depositing the securities of the estate in a custody account with a trust company. The saving in premiums on the surety bond is greater than the charge of the trust company for custody, which, besides, affords its convenient service to the fiduciary.

CHAPTER XLVI

Capital Accumulation. Control over Wealth and its Commitment as Capital in Relation to the Corporate Form

We have considered the corporation as a form of business organization developed primarily to enable a somewhat numerous group to function in conducting enterprise. We have further considered the reason for the development of this corporate group organization as being the growth of enterprise itself into forms requiring larger amounts of capital than an individual or a partnership or a group can supply. We have seen the mechanism of the corporate form, and the attendant mechanisms of investment banking, in the process of collecting capital from individuals and bringing it together in the amounts required for enterprise carried on in units of great magnitude. It may be appropriate to go back of this process of capital collection and consider the necessary antecedent process of capital accumulation.

Many sneers greet any mention these days of economic theory as developed from the time of Adam Smith down to 1929. Maybe some post-1929 style of economist would deny the categories of land and labor, and of production arising out of labor applied to land and in the further fabrication of the product. But even in the South Sea Islands men do not live exclusively by picking up windfalls of the breadfruit tree. With toil applied to some product of the land, men do provide their food and do fashion their dwellings and tools. We might call the results of labor applied to land and its products "exergons." But we don't. The word symbol we give them is "wealth." Men exert themselves to acquire these things. Men did not produce the land, but by their labor they produce everything else they consume.

And this brings us to a further classification made by economists: the division between things produced for consumption in

the direct processes of living, and those things consumed in the process of further production. In the processes of thought and language we call these things tools, and further call them capital. They are the things used directly in aid of production. Perhaps we go astray sometimes in a classification which sets capital apart from other wealth. Since men use shelter to live in, and would not be able to labor unless they continued to live, the houses they live in are used in production in a sense just as real as that in which tools are used. We are not in the least troubled, when an industrial enterprise builds and owns cottages for the use of its workmen, at the inclusion of these houses as part of the capital assets of the enterprise.

Society has built up elaborate processes for the measurement of wealth, and further elaborate processes for exercising control over wealth. Indeed, society has pushed invention so far in the mechanisms of control that, though men control wealth through their economic machinery, they are not always able to control the machine. We need constantly, in our thinking, to get back of the mechanisms functioning in the employment of wealth to the concepts of wealth itself.

MEASUREMENT OF INDIVIDUAL CONTRIBUTION TO THE PRODUCTION OF WEALTH

How much wealth does a given individual produce? One could answer that question only for a Robinson Crusoe before the coming of Man Friday. A man working alone on a patch of earth could credit the whole product to his own effort. From the very beginning of any division of labor, however, it is no longer possible to say just what proportion of the result of the combined effort is due to A, and how much due to B. The two may enter into a bargain about the division of the product, and may abide by their bargain. Though they may profess to make their proportionate contributions the basis of their bargain, the result may indicate simply that B places a more modest estimate on his endeavors than A places on his, or that B is psychologically indisposed to haggling, or that he is under pressure of necessity to come to conclusions, or that in some other way A is a better bargainer, or in a more advantageous position to bargain than B.

If the matter were referred to a presumably impartial arbi-

trator, his ideals would enter into his judgment. To be sure, if both A and B engaged in, say, building a wall, and, with equal accessibility to materials, A began at one end and B at the other, with the result that A built two-thirds while B built one-third, one would evaluate their product in these proportions. But on both working together, B gathering material and A placing it in form, we have opinion coming in as to their relative contribution to the completed value of the wall. Shall we say that the skill of A contributed more to the result than the strength of B? Our individual answers would depend on our relative ideals, as to whether we admire skill more than we admire strength, or vice versa. Bargaining processes tend to reach conclusions on the basis of scarcity or abundance of skill as compared with strength.

Under some circumstances, to be sure, we may be able to measure the contribution made by an individual to results produced through a division of labor. We may have a basis for comparisons. If A, B, and C, working together, but without direction of a boss, take six days to lay a wall, the job represents eighteen man-days of labor. Let them lay a corresponding wall with the assistance of D, a boss, who does not toil with his hands, but directs the operation. If the four complete the work in four days, or sixteen man-days of labor, then it becomes apparent that, if D's contribution had been no greater than that of A, B, and C, it would have taken the four men, not four days, but four and one-half days to do the job, or two man-days more of labor. By saving two man-days of labor in four days, D has done the work of a man and a half of A, or B, or C.

So far we have assumed that the increased product is due to the directive skill of the boss making the exertion of energy by the men more effective. But let us assume that part or all of the increase in product is due, not to a more effective use of a given amount of energy, but to a moral pressure by the boss causing the men to exert more energy. Even here the boss has contributed a moral element which the men failed to supply for themselves. From the viewpoint of society this is the boss's contribution to the product.

We do carry on our bargaining over our shares in the cooperative production in some degree on the basis of relative contribution. When an employer bids for the labor of another, the employer's estimate of the increase in production is one of the elements that enter into the price he is willing to pay. But there

is always present the relative bargaining ability of those who are making the bargain over the share in the product.

POSSIBILITIES OF FUTURE CONSUMPTION

Our real concern in connection with capital accumulation lies with the result following the bargain rather than with the bargain itself. Whatever the bargain is, as a result of it a man finds himself having the control over so much wealth. Some of it he must consume, if he is to continue living. It may be, however, that he has control over a surplus beyond the minimum of subsistence. Under the existing social system of private ownership he has the choice either of immediate consumption beyond the minimum of subsistence or of accumulation.

Possibility of accumulation depends on the existence of wealth capable of enduring. Non-corrosive metals will last, for all practical purposes, forever. Hard grains, with proper storage, will last indefinitely. Many kinds of wealth must be consumed immediately after production.

What reason would men have for refraining from present consumption if these were the only forms in which present command of future consumption could be established? Obviously wealth does not become greater in objective amount by the delay in consumption. The hoarder will not be able to enjoy a greater quantity of wealth in the future. If he accumulates in this way, he does so because of an entirely subjective reason. He thinks his enjoyment in the future of a given quantity will be greater than a present enjoyment of consuming that quantity. He may be accumulating as an insurance against the future. Joseph storing grain in Egypt is the typical example. A hoarder may accumulate because he wants to consume in the future without the toil of production at that future time.

Actuated by this motive he might be well content if the quantitative consumption in the future were less than his present possibility of quantitative consumption. If, for example, he were an obscure Joseph in fear of famine, he might bargain with a neighbor, with a larger barn than his, to store his grain for a compensation of ten per cent per annum of the amount stored.

Our race psychology does not limit the desire for future provision to provision for the accumulating individual alone, or for

himself and his family during his lifetime. His emotions and social concepts may cause him to seek the future welfare of his widow and of his children after his death. He may seek such an extension of his earthly significance as the founding of a family able to stand on the economic advantage which his provision affords.

Hoarding of non-perishable goods will not accomplish much in any of these directions beyond provision for a limited period. When consumption by the individual exceeds his current increment of ability to command wealth, the hoard begins to diminish, and in time will come to an end. If he can exercise his command over wealth to acquire wealth which will produce more wealth, he can extend his provision for the future of himself, his children, and his remoter descendants, over a longer period of time.

Land, after coming into private ownership, offered the earliest medium for this purpose. It does not provide subsistence without the application of labor, but subsistence arises out of its use. Those who are landless will pay, for the use of land to which they may apply their labor, part of the product of land and labor. They will, in short, pay rent (in the legal sense of part of the value in use determined by bargaining, as distinguished from the economic sense of the whole value).

For those whose motive to accumulate was the founding of a family the law of entail afforded for a time a possibility that their hopes for the future should not be frustrated. With the breaking down of entail they must now rely on such devices as the creation of trusts, and the granting of powers of appointment, to continue ownership. Beyond the possibilities in these devices they must rely on class or family custom.

The possibility of legal rent enables the accumulator of wealth in the form of land to become an investor, in the sense of one who commits his wealth, for use in production, to the management of another, so that the immediate control of the use is parted with.

Merchants could, and did, accumulate wealth in merchandise, but as long as their wealth was in this form they had to continue as enterprisers. Their means of investing, in the sense of ownership without management, lay in the land until the comparatively recent development of other forms of investing.

When government resorted to borrowing as a fiscal device, it created a new type of possibility of accumulation. An investor

in the government debt supplies funds in an amount more than enough to pay his share of the current expenses of government. He is in effect making advances to his fellow citizens to cover their full share of the current public expense. He relies on the good faith of the universal agent, the government, to collect these advances through an application of the taxing power, and so effect repayment to him.

CAPITAL AS A MEANS OF ACCUMULATION FOR FUTURE CONSUMPTION

Invention, elaborating the tools used in production into extensive machines, increased the amount of wealth in the form of tools. As economy in production required tools representing larger amounts of wealth, not all who could labor possessed an accumulation of wealth sufficient to enable them to acquire the tools necessary for competition. Growth of population is a factor in the division of labor and capital, just as it is one of the factors creating the landless man and the possibility of rent (in the law sense) out of the ownership of land. We have the constant process of birth of those who have no inheritance of wealth, loss of inheritance by those who have inherited, consumption or loss of accumulations by the accumulators, making up the numbers of those who need to be supplied with tools with which to labor.

So with the development of the tools used in production we have an additional means of wealth accumulation. The tool, including the building to house it, makes a very fair storehouse of wealth. It is not imperishable. It wears out. But it is not swiftly perishable. And through use in production it is able indirectly to reproduce itself. For this purpose accountants set up depreciation reserves. Out of the increase in gross production which use of the machine affords, enough must be set aside to replace the machine before it gives any net increase in production, that is, any real advantage from its use.

In the matter of the tool we come to the economist's concept of capital — wealth used in production. The economist's concept of land and rent as opposed to the concept of capital and interest has this much of valid distinction: land is a necessary factor of any production at all; capital is not a necessary factor in production, but a factor which increases the product.

BARGAINING FOR SHARES IN THE BENEFITS RESULTING FROM THE USE OF WEALTH IN PRODUCTION

How much will the landless man pay for the use of land? Presumably he will not pay the entire product of the land and his labor. He might as well starve to death not working. He must have subsistence in order to labor. The utmost he can pay is limited by the excess of production over subsistence. How much, within this limit, he will pay depends on his bargaining power and ability. As the ratio of acres of land to units of population declines, the bargaining power of the landless declines. Bargaining power depends in part on supply and demand.

Correspondingly we answer the question of how much the man without capital will pay for the use of capital. He will not pay the entire net increase in production. He would do as well without capital. Again, what he actually will pay depends on his bargaining power and ability. And again, in the long run, this power depends in substantial part on the ratio of units of capital to units of population, on supply and demand.

GENERAL SOCIAL BENEFIT FROM CAPITAL ACCUMULATION

There is this further difference between the land situation and the capital situation: though ownership of the land may come into proportionately fewer hands, that is, the ratio of ownership to population may change and affect the bargaining power, the aggregate of the land is not capable of increase. But the aggregate of capital can be increased; and if the increase is such that the ratio of capital to population increases, the bargaining power of capital declines, and it must be content with a smaller proportion of the increase in production due to the use of capital. So it is in the interest of those without capital that the aggregate of capital should increase.

It is sometimes said that the matter of interest, the payment made for the use of capital, increasing the aggregate of objective future enjoyment, is the principal factor in determining the accumulation of wealth and its commitment in the form of capital. Presumably it is a factor, and probably an important one. But, as we have remarked, the matter of future enjoyment is sub-

jective as well as objective. The degree of certainty of future enjoyment is perhaps more important than the objective amount. This is pretty much the same as saying that the subjective aspect of future enjoyment is perhaps more important than the objective. We have indicated the possible example of the man who might pay a percentage of his crop to have it stored for his future consumption. Expressed in monetary terms, a man who could make no better bargain might well accumulate a dollar today if he could be certain of having today's seventy-five cents worth of objects of consumption to enjoy at some future day.

RISK AS AN ELEMENT IN ACCUMULATION

So we come to the matter of risk as a factor in the motivation for accumulating wealth. Leaving aside for the moment all question of the subjective element of enjoyment, the greatest deterrent of accumulation is uncertainty of the objective amount to be enjoyed in the future. A Joseph may be willing to pay part of his grain for storage, so that the amount to be enjoyed by him in the future will certainly be less than the amount he sets aside. He must, however, contemplate such possibilities as that fire may destroy all the stored grain, so that, though he foregoes all present consumption, he may not enjoy any future consumption. Still the subjective value of the corn during seven lean years is so great that he denies himself not only the lesser present subjective value, but chances the possible loss of all future value.

Economists have sought to express the situation in terms of "true interest" and "premium for risk." True interest is said to be the reward for refraining from present consumption assuming a certainty of future objective benefit equal to the amount of present refraining. Expressed in terms of investment, true interest would be the return on capital assuming no risk of loss of principal. Such a commitment is, of course, a pure hypothesis. Nevertheless, on that hypothesis, whatever return is bargained for in excess of true interest is premium for risk.

Let us briefly consider this analysis. What does in fact determine any current interest rate? At one extreme, A would accumulate wealth for less than no objective reward in a greater future amount of consumption. If he could be certain of an amount of future objective benefit, he would actually pay for that

certainty. B would accumulate if he could be certain that his accumulation would not be impaired. And so on to C, D, E, etc. At the other extreme Z would not accumulate for any amount of future objective benefit. Y would do so for a large increase. And so on back through X, W, V, etc. What in fact they can command depends on those who want the use of capital bidding in a market in which capital is for sale.

CAPITAL ACCUMULATION ARISING OUT OF CONDITIONS OTHER THAN THOSE OF SMALL THRIFT

In our visualizing of capital accumulation we are perhaps too likely to see the dull browns and be blind to the vivid crimsons. We see and idealize thrift, the sober saving of $500 from the $2500 income, and the psychology of such provision for the future. In our tremendously hazardous and speculative economic life, in which, to the inescapable risks of nature we add the risks of the social machinery we have developed for our economic processes, this picture of sober thrift covers only a part, and perhaps not the larger part, of the canvas.

Some men acquire control over wealth by more riotous processes. Occasionally a speculator swells a shoestring into the rope of a fortune. An inventor develops something which finds a wide market to his great profit. Enterprisers push business into magnitudes that produce annually incomes equal to the aggregate of those of hundreds of the small thrifty, but for the sustenance of one family instead of hundreds of families. Such situations somewhat strain a theory of capital creation based on a frugal refraining from present consumption to provide for old age. Yet they have this in common with ordinary thrift: at a moment of time an individual has a choice whether he will exercise his present control over wealth to the end of immediate consumption, or whether he will commit the wealth to use in production. If the choice fall on the side of use in production, capital is created just as much whether the consumption refrained from be a new low-priced car or an ocean-going power yacht. Out of the capital a general social benefit arises, as we shall see; out of the car or yacht the consumption benefit remains entirely individual.

The maximum possible bid for the capital so created would be the total increase in production due to the use of capital. But at this point we perceive that those who accumulate capital confer

a benefit on society in general. Bargaining over the use of capital is not simply a line of division of the entire increase in production between those who supply the capital and the enterprisers who use it. Users of capital in seeking a market for their products bid against each other for these markets, and in this bidding, by reducing the price of their product, pass on to society a large part of the increase in production due to the use of capital.

It is, therefore, greatly to the interest of society to foster the accumulation of capital from which it receives a large part of the benefits. Society does not receive that part of the benefits which is paid to the man who bargains for the use of capital, nor that part which is paid to the man who accumulates. But as the supply of capital increases, the amount necessary to pay for it tends to decrease. Society, by doing what it can to decrease the risks of accumulation, fosters accumulation; by increasing the risks, society discourages accumulation.

ECONOMIC DANGERS ARISE, NOT OUT OF ACCUMULATION, BUT THE USE OF ACCUMULATION

A great deal has been said in recent years about too much of the current production of wealth being allocated to capital, so that society cannot consume the increased amounts which can be produced through the use of the increased capital. At least, this seems to be the course of the argument, which is not always easy to follow. It is not argued that society loses its desire to consume any increase which capital may be capable of producing. The argument for more leisure does not amount to that, for the very possibility of leisure is due to the increase. Leisure might be called a form of consumption.

Just as accumulation by the individual defers his individual consumption to a future time, so the aggregate of such accumulation defers the aggregate of consumption to a future time. It may be that an individual is unwise in not using a greater proportion of his total control over wealth for present consumption. He may injure his health by inadequate food. He may cramp his life and dwarf his mind by parsimony. He may not give sufficient consideration to the philosophy of *carpe diem* in the sense of eat, drink, and be merry, for tomorrow we die. As an individual may do these things, so may the aggregate of indi-

viduals we call society. Apart from these considerations there can be no overaccumulation as such.

What can happen is that the capital accumulation, with insufficient prescience, may be committed out of balance. That is, though the capital committed to production will produce more goods for consumption in the future, the future desire to consume may not be for the kind of goods for the production of which the capital has been committed. Here the danger, however, lies in the commitment of the capital, not in its accumulation. And perhaps this danger is greater with a rapid than with a slow increase in the total of capital.

SOCIAL ENCOURAGEMENT OF CAPITAL ACCUMULATION

Economic hazards arising out of the struggle of man with his physical environment are the very reason for the development of capital to cope with them. Capital in turn suffers from these risks — fire, storm, frost, corrosion, decay, etc. A society organized on the basis of private ownership of wealth encourages capital accumulation by the protection which, through government, it affords against theft, robbery, arson, fraud, breach of contract. It encourages the accumulation through the development of instrumentalities for the commitment and use of wealth as capital in enterprise. So we are concerned with the development of the corporation as an effective instrument for this purpose. Society discourages the accumulation of capital whenever it acts in such a way as to frustrate the anticipated benefits which motivate the man who has a present control over wealth to commit it as capital instead of consuming it in present enjoyment. Whoever contemplates such a commitment confronts three classes of risk: (1) the economic hazard arising out of natural forces; (2) the economic hazard arising out of functioning of the economic mechanism; (3) the political hazard that anticipated benefits will be taken from those who sacrificed present enjoyment and transferred to those who have not sacrificed.

Division of labor in production has increased as the use of capital in production has increased. With this increased division of labor arises an increased number of those who, desiring future instead of present benefits from wealth which they control, are not in a position to utilize it as capital in their own enterprises. If they are to have future benefits arising out of its use as capital,

they must commit it to the management of others. They must become investors. We have considered the development of the corporate form as an instrumentality for that purpose. And we have discussed the processes of marketing corporate securities by which the individual investor can use his own judgment as to the risks and make his commitment directly.

INTERMEDIATE INSTRUMENTALITIES FOR THE ACCUMULATION OF CAPITAL

Society has developed some intermediate institutions through which the wealth of those who refrain from present consumption is committed as capital. Current savings of many men are not large enough for individual commitment. And many men feel that they are not competent to make their commitments for themselves. Means have been sought to relieve them of the necessity for exercising judgment.

SAVINGS BANKS

Savings banks, and the savings departments of trust companies and commercial banks, offer the man whose ability or desire for accumulation is small an opportunity to effect it by turning control over to the investing institution. The aggregate of such accounts in an institution is so large that men can give time enough to their commitment as capital. The accumulator escapes the necessity for the exercise of his own judgment in the choice of risks beyond his risk in his selection of the savings institution as the medium of commitment.

INSURANCE COMPANIES

Life insurance companies exist for the very purpose of substituting future for present consumption. The fact that they do so by dealing with policyholders as a group, rather than dealing with each independently of his group relationship, does not change the essential situation of present refraining and future consuming. On behalf of the group the insurance company commits the currently accumulating funds to use as capital in corporate enterprises and to other forms of investment. Many individuals find the periodical bills for premiums on life insurance an assistance in holding them to the process of accumulation.

THE CORPORATION AND CAPITAL ACCUMULATION

This chapter does not in the least attempt to present a complete theory of interest, but only to suggest the process of capital accumulation under an economic system based on private ownership and a freedom of choice between present and future consumption of individual surpluses above subsistence. Any form of social organization seeking a betterment of economic conditions must (aside from the possibility of land conquest) provide for the increase of capital. In our present private ownership system the corporation affords one of the mechanisms through which the motivations for accumulations may express themselves. For this purpose it is a good device. By reason of the corporate group concept, by which the group continues though its members change, the corporation offers the possibility of a time extension of commitments which assists the individual in his endeavor to solve the problem of future enjoyment. Through the division of management and ownership the corporation overcomes a capital commitment difficulty created in part by itself in fostering large scale enterprise with its correlative division of labor. With the increased and increasing division of labor, with the relative decrease in the importance of individual enterprisers, the individual must increasingly commit his accumulations for capital to the management of others.

CHAPTER XLVII

Promotion

One might roughly define a promoter as a man who takes the initiative in getting a business started, or in getting it changed in form or scope, wholly or in a substantial part with other people's capital. The business may be an entirely new enterprise, or a combination of existing enterprises. Or it may even be an expansion of an existing enterprise. If brought about by the efforts of someone who is not performing the work essentially as part of his services as one of the managers of the business, the result is essentially a promotion. The concept is vague. It contains the idea that the promoter usually intends some direct special personal profit from his efforts. One would be readier to say of an individual in a given set of circumstances whether he is to be regarded as a promoter or not, than to formulate a definition which would include all who are promoters and exclude all who are not.

PROMOTING AN ENTERPRISE WHEN ASSETS ARE ACQUIRED FOR CASH AND PROMOTING WHEN ASSETS ARE ACQUIRED FOR SECURITIES

Frequently presentations of the work of a promoter picture him as procuring options on properties useful in the business he attempts to launch, called "assembling" the promotion, finding those who will provide the necessary cash, causing the properties to be transferred to a corporation formed to carry on the business proposed, and in some way obtaining compensation for his efforts. All this is true. But the task of a promoter proposing that the enterprise shall acquire its assets for cash differs substantially from his task when he proposes that they shall be paid for in securities of the corporation to acquire them. Cash payments for assets are more likely to be made in the case of an enterprise which is to begin a business than in the case of one which is to take over and carry on existing businesses.

Frequently an essential part of the promoter's services consists of making the enterprise possible through reducing the amount of cash required to an amount which can be provided from the sources to which he has access. If necessary assets can be acquired for securities of the new corporation, so much less cash has to be raised through the sale of securities. But the promoter who bargains for assets in terms of securities must convince their owner of the probable value of the proposed enterprise.

ONE WASTE OF PROMOTION

Herein lies one of the wastes of promotion from the viewpoint of those who provide cash in a situation in which some assets are acquired with securities. It is so much easier for the promoter to provide securities than it is to provide cash, and so much harder to buy with securities than for cash, that the bargain he makes for the acquisition of property for securities is likely to be disadvantageous to those who buy securities with cash.

We had the essence of the problem in our discussion of capital stock when we considered the illustration of the manufacturer who offered to sell his machine to the new corporation for $20,000 in cash, or $25,000 in bonds, or $30,000 in stock. If the stock is issued for the machine, then (leaving aside all question of the legality of the transaction) those who pay par for the stock in cash must be convinced that the prospects of the enterprise make the stock they buy worth par in spite of the fact that someone else has essentially acquired three hundred shares at $66\frac{2}{3}$, to that extent reducing the capital with which the business must earn compensation for all the shares. We are not raising here any question of promoter's profits, but are assuming that the promoter has dealt at arm's length with the owner of the property.

GOING CONCERN PROMOTION

When the promotion involves bringing together several going concerns into a consolidated enterprise, and the present owners of the concerns are taking securities of the consolidating corporation, the work of convincing these owners of the worth of the securities involves satisfying each owner that his property is being valued as favorably for him as the other properties are valued for their owners. In relation to each other owners can jealously

watch that a fair bargain is being made. But the promoter himself is the only one to see that this bargain is fair to those who will be paying cash for securities.

KIND OF SECURITIES IN EXCHANGE FOR PROPERTY

Owners may be ready to turn their properties into a consolidation provided they get in effect a purchase money mortgage for what is essentially the cash value of the properties, and, in addition, a stock interest in the new enterprise. Then, if the enterprise is successful, they have an investment in an amount equal to the cash value, and a participation in the earnings of success. On the other hand, if the enterprise is unsuccessful they get their property back. This works out exactly in the case of a single large property being turned in. On a consolidation it would look queer to those who are to be asked to provide cash to be confronted with a separate purchase money mortgage and bond issue for each property included.

Under a consolidation, to produce a "set-up" on which cash can be sought, the promoter would have to bargain with the going concerns to sell for bonds secured by a mortgage on the consolidated properties. Such a mortgage effectively scrambles the several properties together, and on default each owner will not get back his separate property and be in essentially the position the owner was in before the consolidation. Still, if they have made a fair bargain as to each other, the properties come back to them as a group either benefited by whatever cash proceeds of securities may have been expended on them, or damaged to the extent of whatever failure of maintenance the consolidated management may have permitted them to suffer in the endeavor to avoid default. In the latter case, however, they will have received as interest whatever should have been expended as maintenance.

When the going concern owners exchange their properties for preferred stock, they retain the preferential benefit of their values, but, whatever happens, cannot cut off the equities of anyone who may supply cash for common stock. Yet here it should be obvious to those supplying cash for common stock that those who have supplied the values in property have stipulated for a preference.

Owners who exchange property for common stock only, permitting preferences to be created by the issuance of creditor securities or preferred stock for the cash provision of the promo-

tion, present the best manifestation of confidence in the new enterprise, or of the consolidation of existing enterprises, as the case may be. Yet those who supply cash may well scrutinize even such transactions. An owner of a non-income producing property may feel that such a transaction offers the best chance of liquidating an asset which taxes are consuming.

The amount of cash a promoter has to seek depends on his degree of success in bargaining for necessary property with securities. Property owners willing to take part payment in securities may, nevertheless, insist on part payment in cash. They are likely to strive for an amount of cash for which they would sell irrespective of securities and add to that an endeavor for securities also. A promoter's urgency to effect his transaction may well lead him to consider properties, not in the terms of cash values, but in terms of hoped for earnings and what the enterprise will stand in relation to them, if they are realized.

CASH PROVISION IN PROMOTIONS

So we come to the problem of providing for the cash necessary in the promotion. As just indicated, the promoter is likely to consider what he has to deal with and parcel out in values, including earnings present or hoped for. How much of these values can he part with to property owners and still have enough left to sell for necessary cash and leave promotion profits? Just as he must persuade each property owner really taking pay in securities that he is getting a good bargain in terms of these values, so he must be able to persuade those who are to provide cash that the values remaining to be offered for cash are a good bargain for the cash. The promoter has so much cloth at his disposal and must cut from it a coat for the property owners, trousers for those who furnish cash, and a waistcoat for himself. Unfortunately, if any of the garments are scanty, it is likely to be the trousers, which, nevertheless, must be sold to the customer.

TYPES OF PROMOTION VARY WITH ECONOMIC CONDITIONS

Since the beginning of the modern use of the corporate form for conducting enterprise, the types of promotion more prevalent at any time naturally have varied as economic conditions have changed.

During the period of railroad building along the Atlantic seaboard, indeed for much of the construction east of the Mississippi, promoters engaged in the laying down of relatively short lines. The promotion process consisted largely in inducing individuals and communities to supply cash in consideration, not only of the return on capital to be made by the railroad itself, but also, and often regarded as more important, in consideration of the benefits, in increased property values and otherwise, of having the railroad run through the community. Promoters got communities to bid against each other to have the line run to or through their town or city. In aid of construction, municipalities delivered to promoters, or their corporations, issues of municipal bonds, which, by reason of the municipal credit, could be sold for cash much more readily than the obligations of the railroad itself. Sometimes, after delivering the bonds, the community did not get the railroad. In railroad construction the promoter had a party to deal with in addition to the owner of property who might be induced to turn it over for corporate paper, and the man with cash who must be persuaded to take corporate paper for it. Railroads involve franchises to cross the highway, and the right of eminent domain. Promoters had to deal with a third party, the politician, and the course of their dealings was often a muddy one.

After the railroad construction period in this territory the promoter had a further opportunity in end-to-end consolidation of the short independent roads into through lines. Meanwhile promoters were initiating the construction of through lines west of the Mississippi. The stories of the promotion of Union Pacific, Southern Pacific, Northern Pacific, and later of the Great Northern are picturesque and familiar parts of our economic history. Then came the period of promoting through lines into railroad systems, which was still in process when the economic events of 1929 and subsequent years put an end to promotions, for the time being at least.

UTILITY PROMOTIONS

Development of gas lighting gave the promoter opportunities. He seized too on urban passenger transportation. Since the promoter was here also concerned with franchises, he continued to have the politician party of the third part to deal with. Pro-

moters found a great opportunity in the interurban electric railway, in electric lighting, and in the consolidation of electric lighting and gas enterprises. As a part of the electrification of the country there was the promotion of the hydraulic electrical enterprises and the long distance transmission of power. After new construction had covered the electric field, promoters turned to the holding company development of electric systems, and had covered most of the country by the time of the stock market break in 1929.

INDUSTRIAL PROMOTIONS

Most of our industrial enterprises had their beginnings as individual or family concerns. Though they became corporations, their stockholders were members of the family of the individual founder, or were those composing the small, essentially partnership, but legally incorporated, founding group. In time some came to have a larger list of stockholders through the admission of investors. But industrial enterprises did not enter largely into the field of promotion until the time of the industrial combinations which came to be called trusts. Here the promoter had a large opportunity and pressed it hard. In the manufacturing division of the industrial field, promotions have largely been of the consolidation type. Repeal of the Eighteenth Amendment brought some promotion of distilling and brewing enterprises at a time when economic conditions had resulted in a cessation of other promotion effort.

By a loose terminology mining and merchandising come under the name "industrial" in the common division of enterprise into railroad, utility, and industrial. Mining has always been and still is a promotion playground. And in recent years the promoter has taken up commercial enterprise, the marketing of goods. He has multiplied the chains of stores, modeled on owner expanded enterprises, and to some extent has consolidated department stores.

So the promoter seizes opportunity out of economic conditions, and in turn by his activity eventually modifies the conditions themselves. To foretell the direction of his endeavors in the future, one would have to be able to foretell all the conditions of the future. Any invention tending to modify existing conditions is likely to open a new field for promotion.

efficiency of the new offset the loss of the old? One surmises that often it would be better not to scrap the old plant so soon, but to put the accruing new capital accumulation to some other use. Has not the initiative of the promoter often led us astray?

One cannot blame the promoter for capital losses from obsolescence due to radically new invention. The course of such invention is seldom clearly foreseeable. With the development of electricity, the interurban trolley gave society a marked social gain in transportation. The promoter could not be expected to foresee the development of the automobile, which was so quickly to change the ratios of consumers' demand for kinds of transportation, and render obsolete vast amounts of capital which had otherwise suffered little from depreciation.

PROMOTER'S COMPENSATION

Though promoters may often have misdirected their efforts from the viewpoint of social utility, and done a disservice to society, the fact remains that initiative must be taken in the endeavor for economic welfare. It is a function of the promoter to take the initiative in the commitment of capital to enterprise. He does this essentially even when he promotes consolidations of existing enterprise, for then he is causing capital to be committed to enterprise in a new form which may be considered a new enterprise. If the new construction or the consolidation is socially desirable, he renders society a service for which he deserves compensation. How much compensation he deserves is another question.

Marxianism draws a dividing line between those who supply capital and those who supply labor, and, overlooking the fact that such a line cuts many men in two, pictures a proper division of the product into a share for each as the essential economic problem of society. Alas! Those who supply labor are divided into many classes, and each class comprises many individuals. Society has the problem of a proper division of product among the classes of labor and of its subdivision among the individuals of each class. It is to be hoped that we shall be able to determine, but hardly to be expected that we shall soon be able to determine, the proper share for promoters, and for each promoter.

In the meantime, under the existing (or at least recently existing) order of society, the primary determination of the share for

the promoter is left to the bargaining of those most directly affected by its payment, namely, those who supply all the capital he does not supply for the enterprises he causes to be launched.

We shall see the process of this method of determination when we come to consider the law of promoter's profits. Essentially, those who have a right to an interest in the enterprise at the time of its launching bargain with the promoter as to what his compensation shall be. And if an actual bargain is not concluded, he is nevertheless entitled to fair compensation, and its amount must be determined in the same way as the determination of any compensation when the parties concerned cannot come into an agreement about it. The process works most imperfectly. Many who are vitally affected are either deemed to have agreed, when in fact there has been no real agreement, or are deemed not to be affected, though in fact they are.

A promoter enters on a highly speculative undertaking. He receives no compensation unless he succeeds in effecting his promotion. The number of efforts that fail is large compared with the number that succeed. If the aggregate of compensation were spread over the aggregate of the effort, very likely the average of reward would be found small. Society has paid for many failures by paying sometimes high prices for success. Hoped for prizes lure men to effort. The phenomenon is not limited to the field of promotion. It is ever a problem of a competitive order to reduce both the number of failures and the price society pays for success.

WHO ARE THE PROMOTERS?

Promotion does not appear until someone hopes for profit out of getting other people's capital into a new enterprise. As we have indicated, the enterprise may be entirely new or previously existing enterprise in a new form. The promoter may be supplying some or even a large amount of capital himself. But if he supplies all the capital, he is not a promoter even though he is launching a new enterprise. Men have made careers of promotion. Often they have been careers of lifelong failure. More frequently promotion has been an incident in life and not a career. Men promote a single enterprise into affording an occupation for themselves. Sometimes a man engaged in a business sees an opportunity for expansion or consolidation in that business, and carries through a promotion. Sometimes a lawyer or a commercial banker takes up

a promotion through an opportunity arising out of his business contacts. Investment banking is often in touch with promotion, and an investment banker may turn to being a promoter from time to time.

THE CORPORATION FOR A PROMOTION

However loosely the words "promoter" and "promotion" are often used, strictly we do not have a promotion unless there is the organization of a corporation, or a reshaping of an existing corporation to carry on an enterprise. For the purpose of this topic we assume the organization of a new corporation. Question arises as to just when in the course of a promotion the corporation should be organized, and subscriptions taken by the corporation from those who are to contribute cash to the enterprise.

Organization of the corporation at an early stage of the promotion has the advantage of determining the exact contract on which capital is to be committed. The certificate of incorporation fixes the authorized capital stock, number of shares, and the classification, if any, of the shares. It states the objects of the corporate enterprise. So when the promoter bargains with those who are to transfer property to the corporation and with those, if any, who are to be committed in advance to supply cash, the agreement can be simply that the transfer of the payment is to be made for so many shares of stock of the corporation. Otherwise each bargain made before incorporation must state that a corporation is to be organized for such and such objects, with such an authorized capital and such a number of shares, and so on. Unless the agreement practically sets forth the contents of a certificate of incorporation, the man who is to transfer property or contribute cash perhaps may refuse to do so on the ground that the shares which are offered to him are not the shares he contracted for.

On the other hand, if the corporation is organized at an early stage of the promotion, it makes the situation less flexible. In the course of bargaining someone may object to the corporate plan and refuse to come into a situation set up in just that way. If the corporate structure has to be modified in the course of promotion, an amendment to the charter must be put through, involving that much extra labor and the complexity of an amended charter. To be sure, without the incorporation any change in

the plan involves the agreement of all the interested parties. But if the charter has been taken out, that must also be amended.

Sometimes the matter may work out the other way. If the incorporating has already been done, the promoter may be able to convince people with whom he deals that the corporate set-up satisfies the purpose for which it is to be used, and so avoid prolonged negotiations to meet the ideas of everyone whom he desires to interest.

Promoters of an enterprise would do well to avoid the pitfall of having the corporation issue stock or take subscriptions until it is certain that enough assets have been absolutely promised to enable the enterprise to carry on. Inexperienced or oversanguine promoters are constantly organizing corporations and having property turned over to them, and subscriptions taken by them, in the hope that in some way they will manage to get enough funds to make a beginning of business and to carry on. Then they find that they cannot obtain enough cash, and that a disagreeable corporate situation exists. At the very least organization taxes will have been paid and reimbursed out of the corporate fund. Probably other expenses will have been paid. The parties cannot be put back in the position they were in before incorporation by simply turning their property back to them.

Of course if the corporation has nothing but cash it can be dissolved and the cash returned to the stockholders diminished by the corporate payments made. But if property has been transferred, those who contributed it must stand their share of the loss along with those who have contributed cash, and a liquidation of the tangibles must be carried through. Further expenses are involved, and there will almost certainly be a loss in values in the liquidation of assets.

It is far safer to carry a promotion situation on by agreements outside the corporation until it has developed to a point at which assets can be turned over to the corporation without great risk of an immediate corporate tangle. The promotion group should underwrite the organization costs. If the promotion reaches a state in which it can with reasonable safety be turned over to the corporate form, those who have supplied organization costs can then be reimbursed. Promoters who are fearful that they may not bring matters to a point at which the corporate enterprise may go ahead, and are unwilling to pay expenses on their own account, should not cause incorporation until the safety

point has been reached. Mention of expenses brings up again the matter of promotion losses as compared with promotion profits. A promoter who does not bring his promotion to the conclusion of a launched enterprise loses all the time he has put into the matter, and often heavy expenses he has incurred.

When, after turning assets over to the corporation, it becomes apparent that the enterprise cannot go forward, the participants, other than the promoters themselves, could be put back in their original positions by the promoters coming forward and making up all deficits. By that time, however, everyone is sore in spirit. The matter has turned into certain loss. Recriminations have begun. Even if the initiating promoter and his associates have enough or any cash with which to pay, they will not part with their cash in order that the corporate property need not be liquidated, but may be returned in kind to those who contributed it.

LAWFUL AND UNLAWFUL PROFITS OF PROMOTERS

As already indicated, a promoter has a right to reasonable compensation for his services in getting the corporate enterprise launched. Such compensation is a proper charge against the corporation. Promoters do not, however, in practice carry through all their work, and when it is completed present a bill to the corporation for the directors or stockholders to authorize payment if they consider it reasonable, or to be bargained about if they consider it unreasonable, and to be settled in the courts if the parties cannot come to an agreement.

By the time the promoter successfully completes his job those who would have to foot the bill, however confident they may still be of success for the enterprise, would be too likely to place a low estimate on the value of the promoter's services. At the best they would be likely to consider fair pay for the time spent as an adequate compensation, without remembering that the promoter took the risk that he would get no pay at all. Even a court, though professing to take into account the speculative nature of the service, is likely to see the accomplished fact, and to be more conscious of a present probability of some payment than of the improbability of any payment which existed when the endeavor began.

In the ordinary course the directors or stockholders would be

astonished to be presented with a bill by the promoter for anything more than reimbursement of organization fees to the State and perhaps attorneys' charges which he has paid. It is the expected thing that the promoter will shape the promotion so that he will "get his" in some way out of transactions connected with the promotion. A most unfortunate aspect of the corporate form of enterprise is that facts are often buried. To have a record appear of a corporate payment of so many dollars for promoter's services would be shocking; to have the promoter take a profit on the sale of property to the corporation is not at all shocking provided the proprieties be observed. A record of the fact of the profit buried in the minute book is a different thing from a record of the payment in the ledger.

MUST DISTINGUISH BETWEEN STATUTORY LIABILITY FOR FULL PAYMENT OF STOCK AND LIABILITY FOR UNLAWFUL PROMOTER'S PROFITS

We must distinguish between (1) the liability for payment of a value up to the full par of stock issued, and (2) unlawful profits of a promoter. Though it is true that both liabilities might arise out of the same transaction, they would still be different liabilities. Consider three cases: (1) If the promoter should transfer to a corporation having other stockholders, for $100,000 par value of its stock, property which he bought for that purpose for $75,000, and should not disclose his profit, he would be liable as a promoter to pay the corporation the profit he made. But if the property should be worth $100,000 he would have no liability for further payment for his stock. (2) On the other hand, if he should disclose his profit, but the property should be worth only $75,000, he would not be liable for promoter's profits, but would be liable to complete full payment for his stock. (3) Still further, if the property should not be worth $100,000, and he should not disclose that he makes a profit, he would be liable both for full payment for his stock and for promoter's profits. Satisfaction of one liability might cancel the other, and it might not, depending on the relationship of value of the property, its cost, the par amount of shares received, and value of the shares. The statutory liability for full payment has nothing to do with the fact of promotion. Liability for promoter's profits depends on the very fact that the profits arose out of a promotion situation.

BASIS OF PROMOTER'S LIABILITY FOR UNDISCLOSED PROFITS

In our general introductory discussion of promotion and promoters we have sometimes used the words loosely, as they are used on the Street. Now that we come to a consideration of some of the legal consequences of promotion, we must be more careful in our language. A man is a promoter when he is in association with others for the purpose of launching a corporate enterprise. The commonest phrase to present the responsibility of a promoter is to say that it arises out of a fiduciary relationship.

What is the nature of the relationship that it should be considered fiduciary, that is, placing the promoter in such a position of confidence that he is not free to deal as if he were on one side of a bargain, and those with whom he deals on the other side? And with whom is the relationship? Those who deal with others for the purpose of getting a corporate enterprise started are in effect engaged in a joint venture of launching the enterprise. Though they may not be formally associated through any specific agreement, the situation brings them into association, however informal. These people with whom the promoter is associated are not in a position readily to protect themselves. Bargains are made to which they are not parties, but which, nevertheless, affect them. To be sure, the law could take the position that in their dealings with the promoter they must protect themselves, however difficult for them to do so. Instead, it takes the position that it is in the social interest to impose a special responsibility on the promoter, namely, not to deal exclusively in his own interest.

To go further with a discussion of principles, however, let us examine the state of existing law. We find on this topic, as in others, that we have, not one law, but the law of forty-eight States and the Federal Government. Our summation will endeavor to present, not the law of any one jurisdiction, but something in the nature of a composite picture, which, however blurred, does show essential features, though not a clear view of the face of any one law.

On looking at such a picture we see that a promoter, i.e., a man who engages in or furthers transactions for the launching of a corporate enterprise, may lawfully make profits for himself, in which his co-enterprisers do not participate, under some cir-

cumstances and may not do so under other circumstances. He may make such profits, provided they are disclosed to all, and consented to by all, who have a right to participate in the corporate enterprise at the time the profits are made. In some jurisdictions the disclosure and consent must extend not only to those who have a right to participate at the time of the profit, but also to all who thereafter come in as participants on the original opening of the books for subscriptions.[1]

FIDUCIARY CHARACTERISTIC OF AGENCY

A common illustration of a fiduciary relationship appears in the situation of principal and agent. It is the agent's duty to make the best bargain he can for his principal, and not to make for himself any gain other than that which his principal allows him. Carried a step further, and a step closer to the promoter situation, a member of a partnership, since he is an agent of the firm, may not on his own sole account profit from his transactions for the partnership without the consent of his partners. The full benefit of all such transactions belongs to all the partners, and the individual may benefit only through his interest in the partnership enterprise. If the agent discloses his proposed profit and his principal, individual or partnership, consents, the agent may lawfully take it.

WHAT CONSTITUTES DISCLOSURE AND CONSENT?

Such a statement still leaves the question of what amounts to disclosure and to consent in the case of launching a corporate enterprise. It may be said generally that we have disclosure and consent in either of two states of fact. (1) If the disclosure is to a board of directors who are really competent to form a judgment, who are in a position to exercise an independent will in acting, who do exercise such a will, and the disclosure of the profit is made to them before they act, then the conditions which the law imposes are satisfied, and the promoter may lawfully take his profit. (2) The conditions are satisfied if the promoter makes the disclosure to all who have a right to participate in the enterprise (and, in some jurisdictions, to all who acquire the right on

[1] For a presentation of the law see Manfred W. Ehrich, *The Law of Promoters.* Matthew Bender and Company, Albany, 1916.

the original opening of the books for subscriptions to shares), and all consent. Each person having the right to participate may consent independently of the others; or, if all who have a right to participate are represented at a stockholders meeting, and, after disclosure of the promoter's profit, vote unanimously in favor of, or ratify, the transaction out of which the profit arises, they may consent in that way.

FIRST BOARD OF DIRECTORS SELDOM QUALIFIED TO ACT FOR ALL WHO HAVE AN INTEREST IN THE ENTERPRISE

Under the actual conditions of promotion the situation would seldom be such that the first board of directors would fulfil the qualifications for assenting to the profits of the promoter on behalf of all the participants. Ordinarily he has caused the corporation to be formed. He has nominated the directors. If they are "dummies," inexperienced men holding subordinate positions in business, perhaps actually employees of the promoter, their vote does not express their will, but the will of the promoter. They are not qualified for good judgment and are not in a position to express a will. If the members of the board are not men of this type, they are friends of the promoter, probably trusting him to such an extent that they do not really exercise judgment in the matter. In any case they would be too unlikely to take a position hostile to the promoter to permit allowing their action to be binding on the other participants in the enterprise. In one way or another the original board of directors consists of men who are not qualified to act under the circumstances. Frequently, indeed ordinarily, we find them resigning to make way for the promoter and his immediate associates as soon after organization as the promoter's transactions have taken place.

BOARD OF DIRECTORS QUALIFIED TO CONSENT STILL MAY NOT RATIFY

So, ordinarily the promoter may not lawfully take his profits on the consent of the kind of original board of directors then acting. It should be remarked, too, that he may not rely on ratification by a board of directors, even by a board whose ac-

ceptance of the transaction at the time it was entered into would have been sufficient to protect him. After the profits have been made unlawfully, the corporation has acquired a right to recover them, and the board has no authority to give away (as by ratification in this case) that which is of value to the corporation. Ratification by unanimous vote at a stockholders meeting, in which all those who have a right to participate in the enterprise are represented, is another matter. They, by so doing, are only giving away what belongs to them; the directors would be giving away what belongs to the participants.

DISCLOSURE TO THOSE PARTICIPATING IN THE ENTERPRISE AND CONSENT BY THEM

In the usual case, then, the promoter, to make profits lawfully, must procure the consent of all who are participating in the enterprise at its launching. Even though, by the time the proposed transaction is presented for action at a stockholders meeting, all those who have rights in the promotion have become stockholders, a majority vote of approval of the promoter's profits is not sufficient. Each and every one has a right to reject a transaction in which the promoter, whom they have joined in launching the enterprise, is making a profit. Since the promotion has characteristics of a joint venture for the purpose of getting the enterprise going, only by the consent of all may the promoter make a profit in which all do not participate.

WHO ARE ASSOCIATES OF THE PROMOTER IN LAUNCHING THE ENTERPRISE?

Next we come to the important question as to just who are to be included among those deemed to be in association with the promoter in launching the enterprise. Specifically, if all who have a right to participate in the enterprise have assented to the profits of the promoter at the time the corporation acts on the transaction out of which the profits are to arise, but immediately, or soon, thereafter additional participants come in by subscribing for stock, is the consent sufficient? What different position in fact are subscribers in when they subscribe immediately before the transaction from the position of those who subscribe immediately after the transaction? The funds of the subsequent sub-

scribers are necessary or desirable to get the business going. It may have been, and probably was, the intention of the promoter from the beginning that they should be invited to subscribe.

DIVISION OF JURISDICTIONS

Yet jurisdictions have divided on the question. And it is one of the ironies of having forty-nine laws in the land of the United States that in a leading case the division appeared on the facts of the same promotion. Bigelow and Lewisohn were co-promoters of the Old Dominion Copper Company, which subsequently claimed that they had made unlawful promoters' profits. Presumably because they could not both be brought within the jurisdiction of the same court, the corporation proceeded against Lewisohn in a Federal court in the Southern District of New York, and against Bigelow in a Massachusetts State court.

The corporation had entered into a contract with Bigelow and Lewisohn to issue to them an agreed amount of stock for certain properties. At the moment when the corporation entered into this contract, they were the only persons with a right to an interest in the enterprise. On funds coming in through additional subscription, however, they would make a profit out of the transaction. Thereupon the corporation took subscriptions for a large amount of additional shares. Were these new subscribers to be deemed associated with Bigelow and Lewisohn in launching the enterprise? If so, then Bigelow and Lewisohn were in the relationship to them of promoters; and, therefore, since the transaction would result in a profit, a fact which had not been disclosed to these subscribers, could the corporation require an accounting for the profits? The Federal court said no.[1] The Massachusetts court said yes.[2]

RESULT OF TRANSFERRING PROPERTY FOR ALL THE SHARES THEN ISSUED OR SUBSCRIBED — NO PROFIT ARISING

In trying to understand the difference in results from exactly the same state of facts, let us consider a concrete situation.

[1] 136 Fed. Rep. 915, 148 Fed. Rep. 1020, 210 U. S. 206.

[2] 188 Mass. 315, 203 Mass. 159. Also see *Bigelow v. Old Dominion Copper Mining and Smelting Company*, 74 N. J. Eq. 457.

Assume that with the intention of starting a corporate enterprise X buys land for \$100,000 in cash, then organizes a corporation and transfers the land to it for \$200,000 par amount of stock, which is all the stock then issued or subscribed. In short, at that moment X is the only person with a right to participate in the enterprise. We will assume further that X made a highly advantageous bargain in buying the land, and that it is actually worth \$200,000. So we have no question of watered stock, which has nothing to do with promoter's profits anyway.

WHEN PROFIT BEGINS TO ARISE

At this point X has not made any profit. He has merely exchanged title to the land for title to the stock which now represents the land. But now forthwith he causes the books of the corporation to be opened for subscriptions, and various people subscribe for \$200,000 par amount of stock and pay \$200,000 into the treasury of the corporation for the shares. Before the subscriptions X's 2000 shares represented just the ownership of the land X had transferred to the corporation. Land and shares were exactly interchangeable values. However, when the additional 2000 shares have been issued and the corporation treasury has \$200,000 in cash for them, we have this corporate balance sheet.

Assets	
Land	\$200,000
Cash	200,000
	\$400,000
Liabilities	
Capital stock	\$400,000

Now X's shares represent the ownership of a one-half interest in land and cash of a value of \$400,000. With respect to the stockholders the land and the cash are not separable. In effect he owns one-half the land and one-half the cash. Further, in effect, he has exchanged one-half the land for one-half the cash, or for \$100,000. But one-half the land had cost him only \$50,000.

If we are to consider the subscribers for cash as X's associates in launching the enterprise, X may then at this point be considered as having made a profit of \$50,000 out of his transactions with these associates. The viewpoint of the Federal

court in the Dominion Copper Case is that they were not his associates at the time of the transaction. The Massachusetts court took the viewpoint that the transaction was part of a plan for launching an enterprise, a plan which included as a further part that additional subscribers should be obtained. Some jurisdictions take the Federal, some the Massachusetts, viewpoint.

A weakness of the Federal position seems to be that under it damage can be deliberately planned without liability arising. To avoid the damage, a subscriber must inquire what, if any, transactions have taken place, and, if any have taken place, be satisfied that he is making a fair bargain when he buys his stock. No one qualified to protect him has acted on his behalf. A fair bargain, to be sure, is not the same matter as promoter's profits. But if the stockholder has the benefit of a fair bargain, one reason for complaint is removed. One reason why the promoter is not permitted to make a secret profit is to remove from him the temptation to make an unfair bargain. To be sure, in any case, if the directors have been negligent in the performance of their duties, the damaged stockholder may hold them; but the realizable value of this liability may be nothing.

Exactly what difference in justice does the Massachusetts position effect? It protects those whose anticipated subscriptions are part of the plan of promotion. But subscribers who come in a year or more later, whose subscriptions form no part of the plan, suffer the loss of the profits just as truly as those who come in before or immediately after the transaction out of which the profits arise. Still, the Massachusetts rule, in a promotion which follows the usual course, does bring in the after-the-transaction stockholders, who can find out whether or not there has been a disclosure, and can take appropriate action. Under the Federal rule all a promoter need do to escape liability is to see that the transaction out of which his profits arise goes through with disclosure to his existing associates, if any, before there are any subscribers for stock.

SITUATION OF A MAN WHO STARTS A CORPORATE ENTERPRISE ACQUIRING ITS STOCK WHICH HE SELLS ON HIS OWN ACCOUNT

Let us consider this further situation. Assume that X after transferring the land for the 200 shares does not cause the corpo-

ration to take subscriptions from other people, but sells 1000 shares of his own stock for $100,000, with which he himself subscribes for an additional 1000 shares. He now owns two-thirds interest in a fund consisting of the land worth $200,000 and cash of $100,000. In effect he has turned into a profit a one-third interest in the land, an interest which cost him $33,333, and gained therefor a two-thirds interest in $100,000 in cash, or a value of $66,666, making a profit of $33,333. The law, however, does not view the people who buy the stock from X as being associated with him in launching the enterprise. Instead it views them as if he had sold them an undivided one-third interest in the land itself without the intervention of the corporate form. They know that X is selling his own stock, and when they deal with him are assumed to recognize that he has a vendor's interest adverse to their interest in the transaction. They must deal in the knowledge that the seller has a right to make as profitable a bargain as he can without misrepresentation.

Our matter comes down to this: in a jurisdiction which follows the Federal rule a subscriber to stock must consider the past transactions of the corporation as *fait accompli,* and as to the consequent corporate values must recognize that the corporate group he seeks to enter has a vendor's adverse interest. On the other hand, in a jurisdiction which follows the Massachusetts rule, subscribers to stock on the *original issuance* have a right to consider that the promoter is inviting them to associate with him in a common venture of launching the corporate enterprise, and that therefore he stands in a fiduciary relationship to them in which he has no right to make an undisclosed profit out of his transactions in the promotion. Of course, if a profit is disclosed before the subscription is made, the act of subscribing agrees to the profit.

WHAT EFFECTS DISCLOSURE?

Must an actual knowledge of the profit be brought to the mind of the subscriber? If there is not such actual communication, is the profit "secret" and therefore unlawful?

As to those who have a right to participate in the enterprise at the time of the transaction out of which the profits arise, the disclosure to them would have to be an actual communication. They must all either assent individually outside of a stockholders meeting or by unanimous vote at a stockholders meeting.

However, in a jurisdiction in which promoters are held to be in a fiduciary relationship to those who subscribe after the transaction out of which the profits arise, to what extent is it necessary to go in order to effect an adequate disclosure of profits before the subscriptions are taken? It is said that subscribers are ordinarily chargeable with notice of all matters spread on the corporate records. So if an offer of the promoters to the corporation contained what would be an adequate disclosure, if actually communicated, and that offer and a statement of acceptance were put on the record, subsequent subscribers would be on notice, and by subscribing would agree to the profit, though as a matter of fact they did not actually know anything about it.

So, unless a man demands and obtains an inspection of the minute book before subscribing, he subscribes at his own risk as to what it contains, for it will be binding on him. In actual practice this is absurd. Practically, a promoter would "get away" with any profit by confining his group, before making his formal offer to the corporation, to a few acquiescent people, all, perhaps, sharing in the profit to be made. Then, after getting a complete disclosure entered on the minute book, he could cause the corporation to go ahead with subscriptions to raise the cash.

NATURE OF THE RIGHTS AND DUTIES ON PROMOTER'S PROFITS

It is the right of those who engage together in the launching of a corporate enterprise that the enterprise when launched should have the full benefit of the promoter's efforts. If the promoter takes secret profits, he has taken a value which ought to have gone into the enterprise. So the rights against the promoter are rights of the corporate group. Such rights are an asset of the enterprise, and may be exercised not only by or for the stockholders in a proceeding taken by the corporation, or by a minority stockholder on behalf of the corporation, but also by a receiver or a judgment creditor.

The person who was actually injured, to be sure, was the subscriber who paid his cash in ignorance of the profit about which he had a right to know. If no such subscriber is any longer a stockholder, then there is no one now in the group who has been injured. All the existing members came in under circumstances in which they must take care of themselves in buying their stock.

On that reasoning there is no one with a right to be made whole. In the Federal courts on suits prosecuted by a stockholder on behalf of the corporation, it has been held that the stockholder must have been such an injured person, i.e., a subscriber or stockholder at the time of the unlawful transaction. Though the rule in the Federal courts seems to rest on the question of jurisdiction, some State courts have followed it.[1] However, the principle stated in the preceding paragraph, based on the corporation having acquired an asset, seems generally to prevail.

REMEDIES

On a case of unlawful profits the corporation may (1) rescind, if the parties can be put *in statu quo*, or (2) may proceed for an accounting to recover the profits. Assume the common situation of a promoter who has sold property to a corporation for its shares. If he still has the shares and the corporation still has the property, the transaction may be undone, rescinded, to use the word of the law, by requiring the promoter to surrender his shares on receiving back the property. Whether the parties can be restored to their former position or not, the corporation (or receiver, or judgment creditor) may proceed to recover the profits for the corporate fund. Presumably the corporation, instead of either rescinding or demanding the profits, may sue for damages done it by the unlawful conduct of the promoter. That is, if the property were not worth as much as the corporation paid for it, and, further, were not worth as much as the promoter paid for it, the profit to the promoter would not be so great as the damage to the corporation arising out of the transaction. Then the recovery in damages would be greater than the recovery in an accounting for profits. However, the facts would seldom be such as to make the damages greater than the profits.

PROMOTION PERIOD — BEGINNING OF THE PROMOTER RELATIONSHIP

We have already considered the question of when the promoter relationship ends, have seen the split of jurisdictions, and seen that some find it ending at the time the corporation enters into the transaction out of which the profit arises, and others find the

[1] Ehrich on Promoters, Sec. 184.

relation continuing through the period of any subscriptions to stock on the original issuance. The promotion period does not begin until the promoter does something which looks toward the launching of the corporate enterprise. It is only profits arising out of transactions entered into during the promotion period that are promoter's profits and unlawful, unless disclosed.

PROMOTER SELLING TO THE CORPORATION PROPERTY HE ACQUIRED BEFORE THE PROMOTION PERIOD BEGAN

When a promoter has owned property before the promotion period began, and has sold the property to the corporation at a price greater than he paid, he has made a profit but not a promoter's profit, and the corporation cannot recover the profits as such. Nevertheless, the promoter has done an unlawful act unless he has disclosed his ownership to all to whom he would have to disclose a promoter's profit in order to make it lawful. A promoter is not an agent of the corporation. At the time he begins his activities there is no corporation in existence for which he could be an agent. However, he is in a fiduciary position like an agent. An agent is bound to make the best bargain he can for his principal, and can have no interest other than that of his principal. If an agent sells his own property to his principal, the agent has an adverse interest. It is the interest of the agent to get all he can for the property, but the interest of the principal to buy it as cheaply as possible.

If the agent goes to his principal and says to him, "I want to sell you my own property," and the principal is willing to go ahead and deal on that basis, the relationship of principal and agent comes to an end, and the relationship of vendor and vendee, dealing at arm's length, begins. If the agent does not disclose that he is the real owner of the property, he is dealing in an unlawful way with his principal. Since the duties of a promoter arise out of his fiduciary relationship, they correspond to the duties of an agent. The essential questions are the same.

When a promoter sells the corporation property he owned before the promotion began, has he brought the fiduciary relationship to an end, and are all the others who have a right to participate in the corporate enterprise dealing with him at arm's length, either directly or through a board of directors qualified by ability

and entire disinterestedness to act for them in the transaction? Unless that is the case the promoter acts unlawfully. If he is selling to the corporation property he owned before he began the promotion, he is not to be considered as having made promoter's profits. Therefore, a proceeding for an accounting to recover the profits does not lie. The other two remedies for his unlawful act, however, are available. The corporation may either rescind the transaction (if the condition of being able to restore the *status quo* exists), or may sue for damages to recover the difference between the price paid by the corporation and the fair value of the property.

It may be remarked that this measure of damages is perhaps not an accurate result of legal theory. The duty arising out of the fiduciary relationship is to make the best bargain possible. Conceivably an agent or a promoter might make a highly advantageous bargain for the purchase of property at less than its fair value. If they could, it would be their duty to do so. So a difference between the price paid and fair value as a measure of damages does not necessarily express the actual damages. Still it would be impossible to determine whether or not the fiduciary could have concluded a bargain for the property, if someone else had owned it at the time of the promotion, on terms more advantageous than fair value. It is a reasonable presumption that the seller would not have dealt except on terms of fair value. So that becomes a practical measure of damages.

Our consideration of lawful and unlawful profits of promoters has followed only the main line of principle, and has not entered at all on various collateral matters, such as a subscriber's action on his own account against promoters for deceit, or subscriber's rescission of subscription for deceit by promoters.

The problem of promoter's profits is inherent in the launching of an enterprise. An actual judgment of their fairness by someone with an interest adverse to that of the promoter seems the only way of dealing with the situation. If such a judgment is made at the time of the transaction out of which the profits arise, then those who come into the enterprise subsequently might fairly have the transaction held conclusive against them. In the usual course of a promotion those on the other side of the fence from the promoter are the people who put up cash against the property the promoter turns in. Under the Federal rule the situation may be that there is no judgment by any such people.

With a disclosure of profits spread on the minute book, a record that, in actual practice, subscribers do not see, there may be no actual judgment by an adverse interest even under the Massachusetts rule.

Provisions of the Federal Securities Act of 1933 seem not to be helpful in the situation of promotion profits. The act requires (Schedule A, Subdivision 20) a disclosure in the registration statement, which carries with it an inclusion in the prospectus, of "any amount paid within two years preceding the filing of the registration statement, or intended to be paid to any promoter and the names of the principal underwriters of such security." But this simply provides a means by which the man who puts up cash may ascertain that there have been transactions with the promoter. It does not effect a disclosure of promoter's profits, or assure the subscriber that there was anyone on the side of the corporation in the transaction to see that the bargain was fair, quite irrespective of profits.

CHAPTER XLVIII

Federal Securities Act

An earlier chapter (XXXI) has set forth the principles underlying the Federal Securities Act of 1933, and shown its essential requirements of the disclosure of facts, and the duty of diligence it imposes. We have seen some of the respects in which its concepts go beyond those of the Common Law, and the artificial thread on which its constitutionality depends. Since its operation greatly changes part of the process of marketing securities, let us examine various provisions somewhat more closely. The reader should remember here, as elsewhere, that this work is in no sense a law text intended to be useful in practice, but simply an endeavor at exposition sufficient for a real understanding of the securities business as it is carried on under present conditions.[1]

THE ADMINISTRATIVE BODY

Originally the act vested supervision in the Federal Trade Commission. The Securities and Exchange Act of 1934 transferred the jurisdiction to the Securities and Exchange Commission. This body consists of five commissioners, whom the President appoints subject to confirmation by the Senate. Not more than three may be members of the same political party. They must make their work as commissioners their exclusive occupation. First appointments were made for the term of one commissioner to expire in each year, and thereafter appointments or reappointments are for terms of five years.

The Commission has organized with eight regional offices in addition to its office at Washington, D.C. These are in New York City, Boston, Atlanta, Chicago, Fort Worth, Denver, San Francisco, and Seattle.

[1] References to C.C.H. in this chapter are to the Commerce Clearing House Service on the Federal Securities Act. A reference to its service on the Securities Exchange Act will be so designated.

Since the two acts, the Securities Act of 1933 and the Securities Exchange Act of 1934, together form a comprehensive scheme for the regulation of the primary and secondary markets in securities, it is, of course, appropriate that the same administrative body have jurisdiction under both. And in connection with our more immediate consideration of the Securities Act as distinct from the Exchange Act the reader should remember that the Exchange Act requires brokers and dealers acting in transactions in securities off the exchange to register with the Commission.

INITIAL CONTRACT IN THE COURSE OF SECURITIES DISTRIBUTION

Perhaps the easiest way to follow the operation of the Securities Act will be to see how it affects each step of the marketing process. We should remember that the pivot on which the act revolves is the transaction in securities. It permits transactions only in issues which are registered; unless (1) the issue is of a kind expressly exempt from registration, or unless (2) the transaction is of such a character that it is allowed even though the issue is not registered.

Among the allowed transactions in securities not registered are those by an issuer not involving any public offering. This presumably covers the contract between the underwriters and the corporation. Whether or not, in any event Section 2 (3) provides that the term "sale," etc., shall not include preliminary negotiations between the issuer and any underwriter. So the initial transaction of the primary marketing process is in the clear. The underwriters can protect themselves by making their commitment conditional on a registration of the issue becoming effective.

TRANSACTIONS ON THE FORMATION OF SECONDARY SYNDICATES

Though we may assume that the purchase from the corporation by a primary syndicate may be made before effective registration, would a sale by the primary syndicate to a secondary syndicate be an exempt transaction? An offering to dealers of a participation in a secondary syndicate being formed presumably is not a public offering. But the exemption of non-public offerings applies to those made by issuers and not to those made by dealers. So an

offering to dealers by the initial purchaser from the corporation has no apparent exemption in the act.

Regulations and rulings so far made apparently do not cover the situation explicitly. It seems rather absurd that the formation of secondary syndicates should be delayed until a registration statement is effective. Yet that would seem to be the conclusion from the construction placed on the dissemination of information prior to the effective date of a registration statement; namely, that such information must not be construable in any way as an offer to sell. Since this prohibition of offers is not limited to public offers, presumably it includes offers by an underwriter to other dealers of participations in secondary syndicates.[1] Perhaps it would be proper, however, for the bankers to enter into an agreement with the corporation to form a syndicate to purchase from the corporation.

That the solicitude of the draftsmen of the act extended to dealers, in the formation of secondary syndicates, appears from the House of Representatives Report[2] commenting on the inclusion of solicitation of an offer to buy in the definition of "sell," etc., which may not be done unless a registration statement is in effect. This report states, as a probability to be guarded against, that pressure might be put on dealers to send in offers to participate, which, although they could not be accepted until the registration statement was in effect, might then be accepted in the order of priority of receipt. It has been said, and very likely has been the case, that the course of business in the formation of secondary syndicates in the past has put pressure on dealers to participate without adequate opportunity to investigate.

THE PUBLIC OFFERING

As we have seen, the issuer may sell as long as it does not make a public offering. An early interpretation of the phrase, while the act was still being administered by the Federal Trade Commission, indicated that an offer to not more than twenty-five would presumably not be a public offering. Therefore an issuer might make such an offering without registering the issue. The Securi-

[1] Opinion of General Counsel of Commission, Release No. 464, August 19, 1935. C.C.H. Service, Par. 4764.021.

[2] H. R. Rep. No. 85, 73d Cong., 1st Ses., quoted in C.C.H. Service, Par. 1640.10.

ties and Exchange Commission has not adhered to this criterion of the number of offerees alone. Opinion of its General Counsel [1] indicates that the number of offerees is only one of several considerations in determining whether or not an offer is "public." It adds questions of the relationship of the offerees to each other, their relationship to the issuer, the denomination of the securities, the magnitude of the aggregate offering, and the manner in which the offer is made. In short, in the present state of interpretation it would be dangerous to make any endeavor of a corporation to sell any securities (unless to an underwriter) without having a registration statement in effect.

ADVERTISING WITHOUT "OFFERING"

One aspect of the act has an element, though perhaps not a large one, of seeming absurdity. Apparently any information, though not extending to the amount, or being in the form, required for a "prospectus" as defined in the act, may be disseminated prior to the effective date of a registration statement, provided it is not construable into an offer to sell or an invitation of an offer to buy. Obviously any dissemination of information by the issuing corporation, or by the underwriters, or by a dealer, is for the purpose of arousing interest so that sales may result. A distinction between arousing an interest in the hope that it may sometime result in an offer to buy and an invitation of a present offer may not seem great. But it seems essentially sound. The intent is that no one shall be inveigled into a commitment, or into a situation which may result in a commitment without further action on his part (as the making of an offer open for acceptance), unless there is extant and available to him the full information required of a prospectus and the Commission has had an opportunity to see that the prospectus actually does contain the information required.

Though the administrative interpretation of the act seems, sometimes at least, to assume the *filing* of a registration statement before the giving of such information, this assumption presumably arises out of the situation that would normally exist. To be sure, the mailing (etc.) of a prospectus before the effective date of a registration statement is forbidden. But a prospectus is something which offers a security for sale (Act, Section 2, Paragraph

[1] Release No. 285, Jan. 24, 1935. C.C.H. Service, Par. 2203.021.

10). Therefore any communication which does not offer for sale is not a prospectus.

RED HERRING PROSPECTUS

Since any information about an issue which is to be sold, at least if it names a price, might inferentially be construable into an offering,[1] it is expedient that the interested corporation, underwriter, or dealer take no chance of such possible construction. Hence the at all reasonably cautious distributor prints in red ink on any printed information given prior to the effective date of a registration statement a legend to the effect that the matter presented is for information purposes only, and does not constitute an offer to sell or a solicitation of an offer to buy, and that orders will not be considered prior to the effective date of the registration statement, and will be considered thereafter only from a person who has previously received a copy of the official prospectus meeting the requirements of the act.

Use of this red ink legend has given rise to the denomination of pre-effective-registration information as "red herring prospectuses." The phrase is a little obscure. We have the saying that a thing is neither "flesh, fowl, nor good red herring." We also have the use of the herring to create a scent, as illustrated by the phrase "to draw a herring across the track." So perhaps the use of the red herring circular is to create a scent which will in the end lead the investor to buy the security. Such red herring prospectuses, in the complete form filed with the registration statement, are used before registration is effective for the formation of syndicates.[2]

PRINTED MATTER CONSTITUTING AN OFFERING: OFFICIAL PROSPECTUS, ANNOUNCEMENT, NEWSPAPER PROSPECTUS

In the marketing of securities the distributors may, of course, use the official prospectus prepared in accordance with the requirements of the act and the Commission. May they use any less elaborate advertisement or circular? To require that all advertis-

[1] We use the word "offering" as the Street does, to include invitations of offers.

[2] See opinion of General Counsel to the Commission, Release No. 802, May 24, 1936. C.C.H. Service, Par. 8543.

ing contain the full information required for the prospectus would make newspaper advertising prohibitively expensive. So the act provides (Section 2, Paragraph 10) that:

> A notice, circular, advertisement, letter, or communication in respect of a security shall not be deemed to be a prospectus if it states from whom a written prospectus meeting the requirements of Section 10 may be obtained and, in addition, does no more than identify the security, state the price thereof, and state by whom orders will be executed.

Readers of the financial pages of newspapers will have observed that to date advertisements usually have contained only the meagre statements of the name of the security, the price, and the offerer (from whom the official prospectus may be obtained). This is sailing under pretty bare poles. Section 10 (b) of the act confers a substantial amount of discretion on the Commission as to the contents of a prospectus. So:

> There may be omitted from any prospectus any of the statements required under such subsection (a) which the Commission may by rules or regulations designate as not being necessary or appropriate in the public interest or for the protection of investors.

Also:

> *** In the exercise of its powers *** the Commission shall have authority to classify prospectuses according to the nature and circumstances of their use, and, by rules and regulations and subject to such terms and conditions as it shall specify therein, to prescribe as to each class the form and contents which it may find appropriate to such use and consistent with the public interest and the protection of investors.

In accordance with this authority the Commission has promulgated provisions for "newspaper prospectuses" which may be used in advertising securities registered on Form 2–A for corporations. This form of registration statement is for issues of seasoned corporations, i.e., corporations which have (a) furnished their security holders financial reports for ten years, or (b) have had a net income for any two fiscal years of the five preceding the date of the latest balance sheet filed with the registration statement. It would be tedious to detail just what matters of the official prospectus may be omitted from the newspaper prospectus.[1] That which must be included extends and crowds the usual quarter

[1] The rule as it stands at the time of writing may be found in Instructions as to Newspaper Prospectuses in Release, May 3, 1934, C.C.H. Service, Par. 6737.

page issue advertisement. A few such newspaper prospectuses have appeared to the date of writing. Mostly, newspaper announcements have been only the name of the issue and price.

WHAT ISSUES MUST BE REGISTERED

So far in this chapter we have considered the course of compliance with the act in the primary marketing of securities, on the assumption that the foundation of compliance consisted of the filing of a registration statement which in due course would become effective. But must such a statement be filed for the marketing of all issues? The answer is "Yes," unless the act provides some specific exception. These exceptions appear in the provisions of Section 3 for exempted securities.

We will especially consider the exemptions which have special importance from our viewpoint of corporation finance.

ISSUES OF CARRIERS SUBJECT TO THE INTERSTATE COMMERCE ACT EXEMPTED

Issues of carriers subject to the provisions of the Interstate Commerce Act are exempted. That act provides for such supervision of railroad security issuance that the legislature considered it unnecessary to bring it under the regulation of the Securities Act.

BUT ISSUES OF PUBLIC UTILITIES SUBJECT TO THE SUPERVISION OF STATE ADMINISTRATIVE AUTHORITIES ARE NOT EXEMPTED

This principle of exempting the issues of carriers subject to the Interstate Commerce Act was not extended to issues of public utility corporations subject to the supervision of State administrative authorities. State legislation may provide for State supervision of security issues of utilities. But the amount of control authorized, and its administrative exercise, vary so widely from State to State that the Federal legislature felt that this State supervision should not be relied on as a basis for exempting public utilities from the Securities Act. Then, too, the whole problem of the issues of non-operating companies which might not come under the jurisdiction of State administrative authorities confronted the Federal administration.

FINANCING OF CURRENT OPERATIONS EXEMPTED

Current financing, that is, an ordinary current liability, is not required to be registered. A maturity not longer than nine months brings the security within this exempted class.

EXEMPTIONS NOT ESPECIALLY RELEVANT TO OUR CONSIDERATION OF THE TOPIC OF CORPORATION FINANCE

A number of exemptions appear, which, however, are hardly within the scope of the subject of this book. One is Federal and State public securities. The securities of foreign governments are not exempted. The act exempts securities of eleemosynary and various coöperative institutions.

COURT SUPERVISION EXEMPTING CERTAIN SECURITIES

If the issuance of a security comes under the supervision and control of a judicial body, it is assumed that its scrutiny and approval provides a sufficient substitute for the purposes of registration. So the act exempts:

(1) Certificates issued by a receiver or by a trustee in bankruptcy, with the approval of the court — i.e., those securities commonly known as receiver's certificates.

(2) Securities issued under a plan of reorganization approved by the court.

(3) Certificates of deposit.

Exemption of receiver's certificates hardly requires comment. We have heretofore seen that the process of issuance involves a court order made after opportunity for hearing those affected by the transaction. With respect to reorganization securities we have seen the court in the process of approving a plan of reorganization in the course of an equity proceeding, and we have considered the provisions of Sections 77 and 77B amending the Bankruptcy Act to provide for reorganizations.

REORGANIZATION SECURITIES

Section 3 (10) of the act exempts

*** any security which is issued in exchange for one or more bona fide outstanding securities, claims or property interests, or partly in such

exchange and partly for cash, where the terms and conditions of such issuance and exchange are approved, after a hearing upon the fairness of such terms and conditions at which all persons to whom it is proposed to issue securities in such exchange shall have the right to appear, by any court, or by any official or agency of the United States, or by any State or Territorial banking or insurance commission or other governmental authority expressly authorized by law to grant such approval; ***

As we have seen, the court approves or disapproves the plan of reorganization in equity proceedings or under the amended Bankruptcy Act. But defaults in real estate mortgage issues developed a possibility of reorganizations without court approval of the plan. It has not been the practice of the courts in an ordinary real estate mortgage foreclosure to fix an upset price. So deposits of bonds or certificates might be procured on a plan of reorganization. Then, without the process of equity proceedings in which foreclosure without the consent of the equity court would be enjoined, the reorganizers could begin foreclosure. Without the requirements of an upset price, the bid might be sufficient only to cover prior claims, and the non-depositing security holders be cut off. State legislative action and court practice have been remedying this situation. It is mentioned only as an indication of reasons for not just exempting all reorganization securities from the registration requirements.[1]

CERTIFICATES OF DEPOSIT

Under the definitions in the act a certificate of deposit is a security (Section 2), and therefore is not exempted from the operation of the act unless the terms and conditions of issuance and exchange are approved by a court, etc., in accordance with the provisions just quoted. Under the same section those who perform the duties of depositor are the "issuer." This is perhaps not very happy phrasing. It is the security holder himself who deposits. But here doubtless the term means the Committee soliciting the deposit. An amendment to the act directed the Commission to "make a study and investigation of the work, activities, personnel and functions of protective and reorganization committees" (Title II, Section 211). Undesirable things have sometimes happened in connection with protective committees.

[1] The reader is referred back to Chapter XLIV, heading "Federal Securities Act."

Such statutory attempts to relieve the investor from the necessity of vigilance may somewhat irritate one who believes in the values of personal responsibility; the magnitude and complexity of group transactions, however, are such that the time and cost of vigilance by the individual member of the group is out of proportion to his single financial interest. So here we have an example of an endeavor to have transactions scrutinized for the benefit of all members of the group by someone whose position creates a stronger presumption of disinterestedness than we have found is created by the volunteer protective committee.

Exemption by the Securities Act of certificates of deposit, if the deposit agreement has court approval, has led to the practice of including in the petition for reorganization under the Bankruptcy Act an application for the court to pass on the deposit agreement. So this becomes a part of the jurisdiction of the court.

VOTING TRUST CERTIFICATES

Correspondingly, voting trust certificates are expressly designated among the classes of securities named in the act. In the past they have often been created in connection with reorganizations. When so to be created in the future, presumably the court can be requested in the application for reorganization to pass upon the fairness of the agreement, and in this way exemption from registration be obtained just as for certificates of deposit.

ADJUSTMENT SECURITIES

One exemption the act provides appears on first reading to open the door rather widely to reorganization and adjustment securities. It provides in Section 3 (9) exemption for "any security exchanged by the issuer with its existing security holders exclusively where no commission or other remuneration is paid or given directly or indirectly for soliciting such exchange."

But in the ordinary reorganization in the course of equity proceedings a new corporation acquires the assets as a result of a judicial sale. In that case the issuer is a new corporation. There is strictly no "exchange" of securities. The new corporation does not acquire the old securities; it acquires the assets of the old corporation. And even if the transaction could be regarded as an exchange, the new corporation would not be exchanging its secu-

rities with its security holders, but with the security holders of the old corporation.

Under a Bankruptcy Act reorganization, to be sure, there is, or may be, an exchange by the issuer with its security holders. In that case there is no new corporation acquiring assets on a judicial sale. Instead, the rights of the security holders in the existing corporation are being readjusted. But in a bankruptcy reorganization the court passes on the plan anyway, and exemption arises under the provision for exemption on court approval. So, for this situation, the exemption for an exchange with existing security holders is not important.

Apparently, however, under this exemption of securities exchanged with existing security holders, an entirely voluntary plan might be carried out without a registration of issues of new securities which a corporation exchanged with its security holders. If this is the case, there appears to be here some recession from the principles of the act. An entirely voluntary plan may be as inequitable as any other. On the full presentation of information required in a registration statement the security holders might not consent. If this exemption of exchanges with existing security holders is not susceptible of this interpretation, it is difficult to see what it does mean. Of course the limitation that no remuneration may be paid directly or indirectly for soliciting the exchange limits the probability of injury. It decreases the likelihood of pressure methods for putting through an unfair adjustment of the capital account.

PUBLIC SALE OF SECURITIES TO PROVIDE THE CASH REQUIREMENTS OF A REORGANIZATION

It will be noted that these exemptions of certain exchanges of securities apparently leave still subject to registration securities sold to the public to provide the cash requirements of a reorganization. Such cash as might be obtained from junior security holders as a condition of their acquiring some of the new securities would seem not to require a registration of the new securities. But the moment an offer were made outside of the old security holders, the issue would have to be registered. Presumably a court, in passing on the fairness of a plan, is not looking to see whether or not any proposed offering to outsiders is fair. Fairness of the plan presumably means fair to the existing parties in interest.

SECURITIES EXEMPTED BY THE COMMISSION UNDER THE AUTHORITY OF THE ACT: LIMITED TO AGGREGATE AMOUNTS OF ISSUE NOT EXCEEDING $100,000

The Commission may from time to time by its rules and regulations, and subject to such terms and conditions as may be prescribed therein, add any class of securities to the securities exempted as provided in this section, if it finds that the enforcement of this title with respect to such securities is not necessary in the public interest and for the protection of investors by reason of the small amount involved or the limited character of the public offerings; but no issue of securities shall be exempted under this subsection where the aggregate amount at which such issue is offered to the public exceeds $100,000.

Acting under this authority the Commission has created a number of exemptions. We will note only those more directly relevant to the topic of corporation finance. A reader should remember throughout our consideration of the Securities Act that its terms include as a security various kinds of financing which are not corporate issues. The regulations creating these Commission exemptions present somewhat elaborate sets of conditions in each case. We are noting little more than headings.

Entire issue of securities sold for cash. The regulations exempt securities sold for cash provided that the corporation receives not less than ninety per cent of the offering price to the public and that no securities of the same issue shall have been issued for anything but cash within a year.

Stock, not all the issue sold for cash. This exemption provides exemption for an issue, although not all the securities of the same class are being, or have been, sold for cash. Moreover, under the conditions set forth, the "spread," or difference between the amount received by the corporation and the price to the public, may be as great as twenty-five per cent of the offering price. There must be a legally effective provision, however, that, until the issuer shall have earned a net profit from operation for a period of one year, the holders of any promotion securities may not dispose of them, or be entitled to any distribution in liquidation until all holders of securities who have paid cash shall have been repaid an amount equal to the net amount received by the issuer on the sale of the securities sold for cash.

Real estate mortgage security. This administrative exemption

is mentioned because the issuer may be a corporation and the transaction essentially one of corporation finance. Although the issue is exempted from registration, the seller must nevertheless supply a prospectus disclosing a required set of facts. As for the other administrative exemptions a variety of other requirements appear.

Certificate of deposit. Certificate of deposit issues within the $100,000 limit are exempted provided the terms of the deposit agreement, and any reorganization plan, with required financial information accompanying the plan, are presented to the depositor in accordance with the general conditions of furnishing prospectus information. The exemption must likewise fulfil other conditions.

Securities exchanged for outstanding securities. This exemption of issues not exceeding $100,000 deals with the matter in the terms required of exempted certificates of deposit, the presentation of the plan, information, etc. Such a regulation in favor of the small reorganization may perhaps have a seeming importance greater than it really possesses. If the exchange takes place under the provisions of the Bankruptcy Act, the court will have approved the plan and the new issue will be exempt under the general provisions of the act.

Voting trust certificates. An administrative exemption of voting trust certificates of issues not exceeding $100,000 is made on condition of disclosure to the security holder of the terms of the trust agreement and certain facts about the trustees.

We are not especially concerned with a variety of other administrative exemptions. Elaborate provisions are made for oil royalty participations. Others appear for mineral rights besides oil royalties, for certain securities issued in connection with reorganization of banks, for mortgage security not exceeding $16,000 insured by the Federal housing administrator.

Such a recapitulation of various administrative exemptions can be taken only as a suggestion of what the Commission has done under its authority. Obviously, for practice, only a close scrutiny and careful following of the full regulation in its complete connection with the act would serve. Anything written about the act, except as indicating its general tenor, is obsolescent the moment it is set down. Practice under the act requires a checking to the moment of action.

STATUTORY EXEMPTION OF SECURITIES SOLD ONLY TO PERSONS RESIDENT OF THE STATE OR TERRITORY WHEN THE ISSUER IS A PERSON RESIDENT AND DOING BUSINESS OR A CORPORATION INCORPORATED BY AND DOING BUSINESS WITHIN SUCH STATE OR TERRITORY

Section 3 (11), exempting what we may call intrastate issuance and sale, seems to indicate a fear of the draftsman that it is not safe to rely on Federal authority over the mails as such. It is only some act in connection with interstate commerce, and using the mails in connection with such commerce, that is forbidden. The thread on which the constitutionality of the act hangs is thin.

Distributors may find themselves pretty strictly limited, however, in the application of this exemption of intrastate transactions. If listing on a stock exchange is sought for an issue which, because it is believed to be an intrastate matter, is not registered under the Securities Act, the Commission may deny it registration on the exchange under the Securities Exchange Act. In this connection the Commission says:

> A stock exchange, such as the New York Stock Exchange, may, because of the intimate and unbroken relationship of transactions on such exchange to the interstate "flow" of securities through such exchange, in itself be regarded as a means or instrument of communication or transportation in interstate commerce.[1]

EXEMPTED TRANSACTIONS

If the act exempts an *issue*, then the issuing corporation, underwriters, and dealers may sell the security without its registration, and, naturally, any investor who has acquired it. But the act also exempts certain *transactions*. For such exempted transactions those who engage in them are not put on inquiry as to whether or not the issue is registered. Essentially, the Securities Act contemplates control of the primary and not of the secondary market. The Securities Exchange Act presents such control as the Federal Government has chosen to exercise over the secondary markets.

[1] See "In the Matter of Brooklyn Manhattan Transit Corporation, 1 S.E.C. 147, June 4, 1935," Release No. 260, Securities Exchange Act Series, June 6, 1935, as quoted in C.C.H. Service, Par. 4845.04.

MARKET TRANSACTIONS BY HOLDERS AFTER PRIMARY DISTRIBUTION

We have seen that the primary attack of the act on the problem of control makes interstate transactions unlawful unless a registration statement is in effect (Section 5). But Section 4 says that "The provisions of Section 5 shall not apply to any of the following transactions," and goes on to enumerate the transactions exempted.

First of these are "transactions by any person other than an issuer, underwriter or dealer." Speaking in general terms, this means market transactions by holders after the primary distribution.

TRANSACTIONS BY AN ISSUER NOT INVOLVING ANY PUBLIC OFFERING

Second of the exempted transactions are those by an issuer not involving any public offering. When presenting the course of sale by the corporation to the underwriter, we considered this class of exempted transactions, and need not take it up further at this point.

DEALER TRANSACTIONS A YEAR OR MORE AFTER FIRST PUBLIC OFFERING

Third of the exempted transactions are those "by a dealer (including an underwriter no longer acting as an underwriter in respect of the security involved in such transactions), except transactions within one year after the first date upon which the security was bona fide offered to the public by the issuer, or by or through an underwriter (excluding in the computation of such year any time during which a stop order issued under Section 8 is in effect as to the security), and except transactions as to securities constituting the whole or a part of an unsold allotment to or subscription by such dealer as a participant in the distribution of such securities by the issuer of, by, or through an underwriter."

This very complex sentence seems rather formidable, but in essence it is simple enough. The act seeks control through achieving jurisdiction over distribution. Once the primary marketing process is complete, the Securities Act leaves any further Federal

control to the Securities Exchange Act. However, the Securities Act does not speak in the words of primary markets and distribution, though it deals with those situations. So in creating exempted transactions it could not just say "all secondary market transactions." Issuer and dealer transactions are the very ones through which control is sought. Nevertheless, to prohibit all issuer and dealer transactions unless a registration statement is in effect would interfere, more than the draftsmen wanted to interfere, with the regular course of business. The act seeks to give the members of the ultimate security holder groups, the investors who supply the funds, the benefit of the information required to be given in registration statements. It seeks to see that they are not only not specifically misinformed, but that they are fully informed. Permitting a corporation to deal with an underwriting investment banker, or group of such bankers, does not interfere with the purpose of the act. The public offering may not be made until the registration statement is in effect.

Further, it is important to the investor that he should have the fullest possible benefit of a free market. One possibility of a free market arises from dealers who may desire to accumulate securities of an issue from investors and subsequently resell them. The transactions of individual speculators are defended on the ground that they help create a market. But the act, on the plan on which it was formulated, could not exempt all dealer transactions. It focuses control on distribution sales. The act must carefully select any dealer transactions which it desires to exempt in order to be sure that the exemption does not open a hole for primary distribution transactions in unregistered issues. So no dealer transactions in primary distribution are exempted at any time. This appears from the provision exempting transactions more than a year from the first date upon which the issue was bona fide offered to the public, "*except* transactions as to securities constituting the whole or part of an unsold allotment to or subscription by such dealer as a participant in the distribution of such securities by the issuer or by or through an underwriter."

Exclusion from the exemption of transactions within one year from the first date of public offering seems to be aimed at evasions of the purpose of the act in requiring disclosure of the information contained in a registration statement. One surmises it is aimed at a situation in which the corporation has not made a "public" issue, but has disposed of securities privately. Though that trans-

action is exempt, the issue is not exempt, and further transactions in the issue would not be exempt by reason of the exemption of the first transaction. To this extent a buyer on a private sale by the corporation finds a limitation of his secondary market.

Why the one-year limitation was made is, at least on casual analysis, not clear. If the security is part of an exempted issue, all transactions are lawful from the beginning. Likewise, if a registration statement has been filed, all transactions are lawful from the effective date of the statement. So the only situation in which the limitations appear applicable is one in which there has been an unlawful public issue, that is, one for which no registration statement has been filed. It seems rather absurd to leave the dealer free after a year in such a situation, when, apparently, he may never act in a transaction on a perfectly lawful privately sold security. Also we have the situation in which the Commission has issued a stop order after a public offering. A subsequent paragraph will mention this matter further. But the limitation of a year seems hardly necessary on this account. There seems to be no reason for prohibiting anything that would help the immediate development of the secondary market. Maybe this paragraph simply shows a failure of analysis. However, it at least raises the question of the significance of the clause.

BROKERS' TRANSACTIONS

Fourth, and last, the act exempts "brokers' transactions executed upon customers' orders on any exchange or in the open or counter market, but not the solicitation of such orders."

It will be noted that this exemption of brokers' transactions does not present the exceptions contained in the allowed exemptions of dealers' transactions.

Exception of the solicitation of orders, of course, does not apply to issues which are qualified for dealing by an effective registration statement. Such transactions need no exemption. The broker is as free to solicit as anyone else. No one is free to sell on initial issuance without furnishing a prospectus.

REGISTRATION SUSPENDED BY STOP ORDER

These exempted transactions have a special significance in connection with one possible situation. Consider the position of an

issue which has been offered publicly after a registration statement had become effective, on which, however, the Commission by the subsequent issuance of a stop order negatived the effectiveness of the registration. Unless the stop is removed, the underwriters may not proceed with interstate offering. And if the stop order prevented secondary market transactions as well as transactions in distribution, great damage would be done investors who had bought before the stop order prevented further distribution. The exempted transactions still leave a secondary market open. This has a bearing on the exemption of dealers' transactions after a year from the first public offering referred to in a preceding paragraph.

CONVERTIBLE SECURITIES AND PURCHASE WARRANTS IN RELATION TO THE ACT

One of the situations which call for remark is the position of convertible securities and purchase warrants in relation to the act. It refers to these situations in Section 2 (3) where it says that

> The issue or transfer of a right or privilege, when originally issued or transferred with a security, giving the holder of such security the right to convert such security into another security of the same issuer or of another person, or giving a right to subscribe to another security of the same issuer or of another person, which right cannot be exercised until some future date, shall not be deemed to be a sale of such other security; but the issue or transfer of such other security upon the exercise of such right of conversion or subscription shall be deemed a sale of such other security.

By the principle that the inclusion of one is the exclusion of the other, presumably if the right to convert or subscribe is not deferred to a future date, but may be exercised immediately, the security which may be converted into or subscribed for is in itself an issue which must be qualified. Indeed, this interpretation was indicated by the Federal Trade Commission referring to bonds carrying a right of immediate conversion into stock, and saying that "for this reason, the issue of the bonds will involve an offer of the stock which will require immediate registration of the latter. A fee for registration of the stock will, of course, have to be paid as well as for the bonds." [1]

It is difficult to see why the situation should require the double

[1] Release No. 97, Part 2, Dec. 28, 1933. C.C.H. Service, Par. 1640.012.

But what does small in number mean — three, thirty, or three hundred? Probably their relationship to the enterprise would be determinative. If it is such that they really know, or are in a position to know, the facts, probably an offer to them would not be public. A group of five stockholders might be in such a position, but a group of more than ten or a dozen are not likely to be. Any corporation should act with extreme caution in relying on exemption on the ground that the offer is not public.

Likewise the Federal Trade Commission has said of an offering of stock to employees that "where a substantial number of persons is involved it would seem imprudent to rely on the second clause of Section 4 (1) to give an exemption." The remarks of the Opinion of Counsel we have referred to appear to indicate the right approach. Employees as such are not likely to be in a position to have or to obtain an adequate knowledge of the pertinent facts, and no matter how small the group, an offer to them presumably would not be exempt.

Both these results seem sound. Employees do not have access to stockholders meetings and do not have even the nominal opportunity to make inquiry into the affairs of the enterprise. Though stockholders do have the nominal opportunity, they do not in fact take advantage of it; and if they tried to do so, would probably not get much information from executives reluctant to give it. In actual experience both employees and stockholders are, for the purposes of the act, as much the "public" as any people who are not in either of these relationships.

REGISTRATION STATEMENTS — FURTHER CONSIDERATION

We have already considered (in Chapter XXI) the information which the act requires a registration statement to contain. However, the act provides (Section 7) that

> *** the Commission may by rules or regulations provide that any such information or document need not be included in respect of any class of issuers or securities if it finds that the requirement of such information or document is inapplicable to such class and that disclosure fully adequate for the protection of investors is otherwise required to be included within the registration statement.

Under this authority the Commission has classified registration statements in accordance with certain "rules" presented in

the Regulations, and prepared forms with instructions. The details of these rules, forms, and instructions do not come within the scope of this treatise, which endeavors only to present the general nature of the statute and work of the Commission under it. It is enough to say that, for example, Form A–2 is a special form of registration statement for security issues of seasoned corporations, and so on for a dozen or more forms already devised.

SPECIAL REGISTRATION STATEMENTS FOR CERTIFICATES OF DEPOSIT AND FOR REORGANIZATION SECURITIES

Certificates of deposit may be proposed either in anticipation that a plan of reorganization will be formulated or after the formulation of such a plan. Especially in the case of a Section 77 B reorganization a plan might be proposed and presented to the court at the same time with a form of deposit agreement. If that is the case Form D–1 naturally must contain information concerning the proposed plan of reorganization in addition to the information required in connection with the deposit agreement. In either case, if, as we have heretofore considered, a registration statement is necessary for the reorganization securities, the Commission has provided Form D–2 for such securities.

EFFECTIVE REGISTRATION

"The effective date of a registration statement shall be the twentieth day after the filing thereof, except as hereinafter provided," etc., the act reads. It is the tenor of the statute that the Commission shall have such reasonable opportunity as a twenty-day period affords for an examination of the statement to see if it furnishes the required items of information, and if the internal evidence does not suggest a possible falsity of the statements.

Ostensibly the delay also gives interested people an opportunity to ascertain the statements made and to deliberate on them in anticipation of action. When filed, the statement is a public record. The Commission will furnish photostatic copies at reasonable rates. Simply filing the statement, however, presumably does not in itself, and will not, accomplish much towards any general public dissemination of its contents, except as news and other information agencies may dig it out and give it publicity. Otherwise, in practice that will happen only to the extent that the

underwriters venture to publish information prior to effective registration. They are not likely to venture much.

During the twenty-day period the Commission does have an opportunity to examine the statement. If in form it does not comply with the requirements, or if, on examination, the statements raise a doubt as to their truthfulness, the Commission, during the twenty-day period, may issue an order refusing to permit the statement to become effective until it has been amended in accordance with the order. If an amendment is filed pursuant to an order, the act provides that it shall be treated as part of the registration statement; and so, presumably, the running of the twenty-day period continues to be computed from the date of the original filing.

After the original filing the issuer itself may wish to file a voluntary amendment. It may have discovered some omission or error, may indeed have been aware of an omission on the original filing. In such a case the issuer may voluntarily file an amendment. If it proceeds in this manner, the twenty-day period starts to run afresh, i.e., it will not have run until twenty days from the date of filing the amendment. If the issuer desires to avoid the delay, it may seek the consent of the Commission to the filing, and, on the granting of consent, the period runs, as before, from the date of the original filing. That is, the act preserves to the Commission, in any event, a reasonable opportunity to examine the information presented.

If the Commission issues an order suspending the running of time, it must do so within ten days after filing and must give notice of an opportunity for a hearing within ten days after notice. Telegraphic notices may be given, but such notice must be confirmed.

STOP ORDERS

Although the act provides for this course of bringing the registration statement into conformity with requirements, the act does not limit the control of the Commission to this process, but provides, in Section 8 (d), that:

> If it appears to the Commission at any time that the registration statement includes any untrue statement of a material fact or omits to state any material fact required to be stated therein or necessary to make the statements therein not misleading, the Commission may, after notice by personal service or the sending of confirmed telegraphic notice, and

after opportunity for hearing (at a time fixed by the Commission) within fifteen days after such notice by personal service or the sending of such telegraphic notice, issue a stop order suspending the effectiveness of the registration statement. When such statement has been amended in accordance with such stop order the Commission shall so declare and thereupon the stop order shall cease to be effective.

Just what difference there may be between a statement that "is on its face incomplete or inaccurate in any material respect" (which lays the foundation for suspension of the running of time), and its appearing "to the Commission at any time that the registration statement includes any untrue statement of a material fact or omits to state any material fact required to be stated therein, or necessary to make the statements therein not misleading" (which lays the foundation for a stop order), appears to lie in the words "on its face." If the registration statement is complete, then the word "inaccurate" would appear to include all of the matters on which a stop order may be issued. The practical upshot of the matter is that the Commission retains control after the registration statement has become "effective." It may apparently issue a stop order at any time, before or after a statement has become effective.

This provision for a stop order after a registration statement has become effective is pretty drastic. To be sure, there is an appeal to the courts. But the issuance of such an order would so interfere with, and perhaps completely kill, distribution of the securities, that it would cause great and irreparable damage to the underwriters. To be sure, the fact that it may be issued puts the greatest possible pressure on those causing the statement to be filed to see that it is accurate. With all the other dangers of inaccuracy, however, inherent in liability to investors, it seems doubtful if this harsh provision is necessary. Indeed the act in several respects contains suggestions of vindictiveness.

COURT REVIEW

"Any person aggrieved by an order of the Commission may obtain a review of such order in the Circuit Court of Appeals of the United States, within any circuit wherein such person resides or has his principal place of business, ***." As already indicated, damage done by a stop order after effective registration would be irreparable. Delay in the effective running of time by a suspen-

sion or a stop order before effective registration would not be so certainly damaging. Underwriters may protect themselves by making their commitment conditional on the registration statement becoming effective.

THE PROSPECTUS

Quoting the act, Section 10 (a):

A prospectus — (1) when relating to a security other than a security issued by a foreign government or a political subdivision thereof, shall contain the same statements made in the registration statement, but it need not include the documents referred to in paragraphs (28) to (32), inclusive, of Schedule A; ***

Documents referred to in paragraphs (28) to (32) inclusive are supporting data, such as the certificate of incorporation and other matters on which the information in the registration statement are based.

Section 10 (d) of the act provides that:

In any case where a prospectus consists of a radio broadcast, copies thereof shall be filed with the Commission under such rules and regulations as it shall prescribe. The Commission may by rules and regulations require the filing with it of forms of prospectuses used in connection with the sale of securities registered under this title.

Rule 800 of the Regulations requires that:

(a) Five copies of the form or forms of prospectus proposed to be used upon the commencement of the public offering of a security shall be filed as part of the registration statement at the time the statement is filed.

(b) Within five days after the commencement of the public offering, twenty copies of each form of prospectus used in connection with such offering shall be filed with the Commission in the exact form used.

(c) No prospectus which purports to comply with Section 10 and which varies from any form of prospectus filed pursuant to paragraph (b) of this Rule shall be used until twenty copies thereof shall have been filed with the Commission.

(d) Every prospectus consisting of a radio broadcast shall be reduced to writing. The user of such a prospectus shall file five copies thereof with the Commission at least five days before the prospectus is broadcast or otherwise issued to the public.

One may indulge in a little speculation about the effect on a radio audience of a speaker persevering through a prospectus

which must begin with the statement that "These securities have not been approved or disapproved by the Securities and Exchange Commission," and continue with all the information of the registration statement.

Not even an Act of Congress can make a horse drink or an investor read and intelligently consider information. The Securities Act says, however, not exactly that the horse shall be led to water, but that water shall be carried to the horse. To be sure, as far as concerns the duty of the carrier of water under the act, it is immaterial that it is carried to a dead horse. That is, an investor may respond to a lawful post-effective-registration advertisement naming only the title of the security, the price, and the person from whom a prospectus may be obtained, and send an order for the securities. The dealer may accept the order. To be sure, the dealer must transmit a prospectus with the security being delivered. But the investor is already bound. If he does not like the facts the prospectus presents, he cannot reject the transaction. If the statements made as facts are true and complete, he has no rights against the dealer.

INCLUSION IN REGISTRATION STATEMENT AND IN PROSPECTUS OF PRICE AT WHICH SECURITY WILL BE SOLD

Item 16 of Schedule A of the act provides that the registration statement shall contain

> *** the price at which it is proposed that the security shall be offered to the public or the method by which such price is computed and any variation therefrom at which any portion of such security is proposed to be offered to any person or classes of persons, other than the underwriters, naming them or specifying the class. A variation in price may be proposed prior to the date of the public offering of the security, but the Commission shall immediately be notified of such variation; ***

Correspondingly, the prospectus must contain the price; and, as we have seen, the regulations require that copies of the forms of prospectus used on the actual offering must be filed within five days after the offering.

Apparently it is the intent of the statute that a change in price after filing the registration statement shall not be considered an amendment to the statement with all requirements and consequences of amendments. The essence of the act does not place

any burden on the Commission to see that the bargain proposed is a fair bargain, but only to see that substantially adequate information is available from which an investor may draw his own conclusions as to the fairness of the bargain. One could wish that the act were clearer with respect to a change in price not requiring amendment to the statement. A change in price proposed prior to the date of public offering must be notified to the Commission, but one infers that a change in price after the first public offering would not have to be so notified. Yet such a change to a higher price would increase the "spread," which is a very pertinent fact.

DAMAGES CONSEQUENT UPON INCORRECTNESS OF MATERIAL FACTS IN REGISTRATION STATEMENT

Chapter XXXI indicated those who become liable for damages by reason of an incorrect registration statement, but did not deal with the matter of the amount of damages. As first enacted the statute provided simply that the recovery should be either (1) the consideration paid for the security with interest thereon, less the amount of income received, conditional on tender of the security back to the seller, or (2) if the person having the right of action no longer owned the security, then he might have damages. That is, the remedy was rescission when that was possible through putting the parties *in statu quo*. If the parties could not be put *in statu quo*, damages might be awarded. But the act did not lay down a statutory rule of damages.

An amendment has omitted the remedy of rescission and enacted a rule for the measure of damages. If the damage has been liquidated, that is, ascertained by an actual sale of the security before the action is brought, then, naturally, the measure of damages is the difference between the price paid and the price realized. If there has been no liquidation, and no sale takes place between the time of bringing the action and the time of judgment, then the value of the security at the time the action is brought determines the damages the judgment will award. But if, after bringing the action, the plaintiff sells the security for a price greater than the value at the time the action was brought, then the damages cannot be greater than the amount actually ascertained by that subsequent liquidation.

It should be remembered that the statutory right to damages

is given not alone to the person who acquires the security from the distributors, but to any person acquiring the security. The statements of the registration statement made representations, so to speak, to the world at large. Since this is the case, conceivably a security sold at 100 could advance in the market to 300, be acquired by someone at that price, and subsequently drop to, say, zero. Under the statutory rule as so far stated, the damage would be 200, or 100 more than the price at which the distributors sold the security. To mitigate the situation and make the damages no greater than the damages of a buyer from the distributors would be, the statute provides that an underwriter shall not be liable for an amount in excess of the price at which the securities were distributed. This limitation applies to underwriters only, and leaves the unmodified rule to apply to persons signing the registration statement, directors of the issuer, and experts.

One modification of the rule presented in the amendment is perhaps (and perhaps not) intended to mitigate the injustice of a liability when there is no real damage because the buyer did not in fact know the representation in the registration statement. Whether or not with any such thought, the amendment to the act provides, in Section 11 (e), that

> *** if the defendant proves that any portion or all of such damages represents other than the depreciation in value of such security resulting from such part of the registration statement, with respect to which his liability is asserted, not being true or omitting to state a material fact required to be stated therein or necessary to make the statements therein not misleading, such portion of or all such damages shall not be recoverable.

The clause itself has nothing to do with reliance or non-reliance. It mitigates damages in either case, and presents a rule very different from that ordinarily applied. Damages on a sale based on a misrepresentation, which the buyer has relied on, go on the idea that the buyer would not have bought if he had known the truth, and the misrepresentation has caused him damage in the amount of his total loss. Here the statute goes on the idea of the difference between the amount of value in fact acquired and the price paid, which represented the value believed to be acquired. It does not take into consideration the thought that the buyer might not have bought at all if he had known the truth. In principle this is a very great difference. In practice it will present to the courts

some pretty difficult questions of fact. And it is to be noted that the burden of establishing the diminution of damages rests on the defendant.

LIABILITY FOR VIOLATING ACT BY SELLING WHEN NO REGISTRATION STATEMENT IS IN EFFECT, ETC.

Any consideration of the statute should not overlook the fact that its scope extends much further than the placing of special responsibility for accuracy and completeness of information on persons signing registration statements, directors, and underwriters, that is, those engaged in the primary marketing. Section 12 provides that:

> Any person who — (1) sells a security in violation of Section 5,[1] or (2) sells a security (whether or not exempted by the provisions of Section 3, other than paragraph (2) of subsection (a) thereof), by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission, shall be liable to the person purchasing such security from him, who may sue either in law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.

Paragraph 2 of subsection (a) contains an exemption of Federal and State government and of municipal securities. As far as the act goes, apparently a seller may be entirely careless of his statements on such issues.

We must remember that damages discussed in the preceding paragraphs are those which arise solely out of the inaccuracy or incompleteness of a filed registration statement. Section 5 makes it a violation of the act to sell unless a registration statement is in effect. But a statement may be inaccurate and still be in effect. Its inaccuracy gives the Commission a right to nullify the effectiveness of the registration, but until nullified the statement is in

[1] I.e. in interstate transactions unless a registration statement is in effect.

effect. So apparently this additional provision (in Section 12) for damages does not extend the liability of underwriters, etc., for incorrect statements. And, anyway, it would be contradictory to have two sets of penalties for the same act — a failure to fulfil the responsibility for the correctness of statements.

So a person who sells a security in violation of Section 5 is one who sells when no registration statement is in effect. But if a transaction is exempted, it is not a violation of Section 5 to sell when no registration statement is in effect. We have already considered those transactions which are exempted. Those of an issuer in any public offering, those of an underwriter, and those of a dealer within one year from the first date on which the security was offered to the public are not exempt. So for these persons to sell without an effective registration statement would be a violation of Section 5, giving rise to the liability created by Section 12 now under discussion.

If no registration statement is filed, there can be no inaccuracy of a registration statement at the time it becomes effective, which is the fault giving rise to the damages on inaccuracy of statements. Then the damages arise out of the act of selling when no registration statement is effective. But suppose a registration statement containing inaccuracies became effective, but the Commission subsequently nullified it by a stop order. Then if an issuer or underwriter continued to make sales there would be two derelictions of duty: one, the failure of accuracy; the other, selling without an effective registration statement. The act provides damages on each dereliction. Are the liabilities cumulative? The question is left standing, without an attempt here to answer.

Damages provided for distribution selling when no registration statement is in effect continue in the form which the act originally presented for inaccurate statements — rescission, or damages (without any special limitations) when, because the parties cannot be put *in statu quo*, rescission is not possible.

LIABILITY FOR VIOLATING THE ACT BY SELLING WITH INACCURATE OR INCOMPLETE STATEMENTS

Here we come to the second part of Section 12 quoted under our preceding topic heading. Now we are not dealing with violations of the act (1) by filing registration statements which are inaccurate or incomplete, or (2) with selling without a registration

statement being in effect, but with anyone, issuer, underwriter, dealer, or investor, either in the course of distribution, or in the secondary market, giving inaccurate information when selling.

Apparently this provision of the act does not impose the duty of adequate information imposed on issuer and underwriter in filing registration statements and presenting prospectuses. We take a step back in the direction of the Common Law. Unless issuer or underwriter, or dealer within a year, etc., the seller has no duty to furnish information. If he does furnish information, however, he must make it full enough not to be misleading. The liability does not get back to the Common Law, however, but remains very much statutory. The purchaser may not know of the "untruth or omission," may not have relied on the statement, may not have found in it any part of his inducement to buy. Nevertheless he may hold the seller. Still the act presents the statutory mitigation. Diligence is the test. We do not have the Common Law absolute liability for representations.

We should note, in connection with our consideration of the liability which the act imposes on anyone who sells by use of a prospectus or oral communication which includes an untrue statement, that the act defines a prospectus as "any prospectus, notice, circular, advertisement, letter or communication, written or by radio, which offers any security for sale." An underwriter, etc., must put the required information in a prospectus. And the definition further states, in Section 2 (10) (a), that:

> *** a communication shall not be deemed a prospectus if it is proved that prior to or at the same time with such communication a written prospectus meeting the requirements of Section 10 was sent or given to the person to whom the communication was made, by the person making such communication or his principal, ***

What would the liability be if a communication contained an untrue statement, but was not a "prospectus" because a written prospectus meeting the requirements of Section 10 was also furnished? Suppose the buyer reads and relies on the untrue statement. Apparently Section 12 imposing a liability for untrue statements in a prospectus does not apply, for the untrue statement is not in a prospectus as defined by the act. Would the Common Law liability apply, or would the buyer be deemed to be on constructive notice of the truth because he knows that the statements on which he has a statutory right to rely are in another paper? Again we make no attempt to answer the question.

CRIMINAL PROVISIONS OF THE ACT

A simple provision of the Federal Code making it a criminal offense to use the mails in any scheme to defraud has long been an effective weapon against those who sold fraudulent securities. Though the frauds were criminal under State laws, the effectiveness of Federal authorities, unhampered by State boundaries in the pursuit of the criminal, made this provision probably the most useful of all means of suppressing security frauds, at least until the general adoption of State Blue Sky Laws. However, this extends only to use of the mails. The fact that it does not reach to other means of communication was an important reason for the development of "boiler factories," as a battery of telephones manned by men aiming at the members of a "sucker list" along the lines of the telephone wires is called. The Securities Act makes a Federal penal offense of fraud in securities by any means of communication.

So far, too, we have considered only the civil liability for damages, etc., imposed. This arises irrespective of intent. Section 24 makes a wilful violation of the act a penal offense punishable by a fine of not more than $5000 or imprisonment for not more than five years, or both.

Since this penalty covers any wilful violation of the act, it applies to Section 17 (a) which makes unlawful the employment "of any means or instruments of transportation or communication in interstate commerce or by use of the mails, directly or indirectly — (1) to employ any device, scheme or artifice to defraud," in the sale of any securities.

One provision of the act aims at touting securities. Publication of what appears to be a financial news sheet which, along with some general financial news, touts special securities has been one of the stock devices of the unethical (to use a mild word) distributor of highly speculative (again a mild word) securities. And there was testimony in one of the Congressional investigations about a newspaper man writing financial news or comment and taking money from those interested in securities he wrote about. Probably such a case is very exceptional. In connection with other acts such conduct might be proved part of a scheme to defraud. The Security Act makes it unnecessary to prove a fraudulent scheme, by making the publication unlawful in itself. In the terms of the act, Section 17 (b):

> It shall be unlawful for any person by the use of any means or instruments of transportation or communication in interstate commerce or by use of the mails, to publish, give publicity to, or circulate any notice, circular, advertisement, newspaper, article, letter, investment service, or communication which, though not purporting to offer a security for sale, describes such a security for a consideration received or to be received, directly or indirectly, from an issuer, underwriter or dealer, without fully disclosing the receipt, whether past or prospective, of such consideration and the amount thereof.

The wording seems unfortunate, and could readily be construed to require that an unmistakable advertisement of information about securities must disclose the consideration. Furnishing information about a security which is not offered for sale, etc., is not prohibited even before the effective date of a registration statement. It is not the tenor of the act to discourage, but to encourage, the dissemination of information about securities. If the information is clearly advertising, there is no deceit. But this provision of the act appears to be aimed only at deceit. It seems to be unhappily, even dangerously, worded, and in need of revision.

For emphasis the caution is repeated that this chapter and the earlier one on the Federal Securities Act are not intended for the purposes of practice, but only to indicate beliefs and impressions of the tenor of the act.

Tenth Section

Secondary Market of the Stock Exchange

CHAPTER XLIX

The Stock Exchange as a Secondary Market for Securities

We have already (in Chapter XXXV) considered the process of listing an issue on the New York Stock Exchange, but further than that have merely indicated the existence of this important secondary market in securities. It is the purpose of this section of the book to present a summary of the course of transactions executed on the Exchange. Unless otherwise expressly indicated, the entire presentation will be in relation to the New York Stock Exchange, and to transactions initiated in New York to which the law of that State applies throughout. Though subject to variation in other jurisdictions, the general fundamental principles usually apply elsewhere.

BROKERS

Throughout this work we have used the words "broker" and "dealer" on the assumption that they were generally understood. Perhaps it would be well at this point, however, expressly to indicate the distinction.

A broker is an agent acting for his principal. Stockbrokers execute orders, that is, buy and sell securities for their customers, and take their compensation for their services in commissions.

Dealers buy and sell on their own account. They sell securities they own themselves, and own the securities they buy. The situation is essentially the same, whether they act individually or as participants in a syndicate. If they are members of a syndicate, they have their pro rata ownership in the syndicate issue. They have the risk of the transaction.

On the other hand, brokers have no risk of the transaction itself. Like anyone else acting for another, they owe to the person for whom they act a duty of careful, diligent performance of their undertaking. So a stockbroker becomes responsible to his customer for having an adequate knowledge of the occupation, and

for employing that knowledge with the diligence and skill that a broker ought to exercise. If he does not so act, he is liable to his customer for any damage the failure of duty may cause. There is nothing in this peculiar to brokers. The same principles apply to a bricklayer undertaking to build a wall for another. Aside from the responsibilities arising out of the fiduciary relationship of agent to principal, the only essential way in which the responsibility of a stockbroker differs from that of a bricklayer is that the kind of skill required of him is different from the kind of skill required of a bricklayer.

Obviously the same individual may at one time be acting as broker and at another time as dealer, though the Securities Commission hopes to segregate the two functions.

BECOMING A MEMBER OF THE STOCK EXCHANGE

A stock exchange is a private association of member brokers. Only those brokers who are admitted to membership are permitted to transact business on the exchange. The New York Stock Exchange has a membership of 1375. This figure represents an increase from 1100 in 1929, when the Exchange gave each member a one-quarter right to a membership. Like a fractional right to a share of stock, these fractional rights to membership could be assembled into a full right of membership.

Since the authorized membership list is full, that is, there are, so to speak, no "authorized and unissued" memberships, the only way in which a man can become a member, or acquire a seat on the Exchange, as the process is phrased, is by transfer of the seat of an existing or a deceased member. For a seat on the Exchange is a kind of property. One who wishes to become a member seeks some member who wishes to dispose of his seat and retire, or seeks the legal representative of a deceased member having the decedent's seat to dispose of, and negotiates for its purchase. He will make a contract to buy the seat conditional on admission to the Exchange. For he does not become a member and acquire the right of trading on the floor merely through buying a seat. He must be a person acceptable to the association, which, for this purpose, acts through its membership committee. The scrutiny of the applicant is no mere formality. It is important that he be a man of such character and financial responsibility as to fit into the business association with his fellow members.

A seat is a property of substantial value. The Exchange seeks to make this value a security to other members for the liabilities of its owner to them. Stock Exchange brokers, in the ordinary run of their business, continuously enter into unsecured contract liabilities to each other. Since in buying and selling securities in regular course they do not disclose to each other the names of the principals for whom they are acting, the contracts of the brokers become their personal liability to each other, as if they were undertaken on their own accounts. They are, in fact, guaranty brokers, guaranteeing performance of the undertakings of their undisclosed principals.

So the constitution of the Exchange provides that, when a member fails to meet his obligations, his seat may in due course be sold, and the proceeds applied first towards the satisfaction of the claims against him of fellow members and their firms arising out of contracts made on the Exchange. The courts sustain that preference. However, the Exchange inquires into the source of the funds with which the seat will be bought in order to see that the applicant is not undertaking to give as security to a lender a prior claim on the value of the seat. Even if such an arrangement is made, the claim on the seat is secondary to those of the Exchange and its members.

ORGANIZATION OF THE EXCHANGE

At an annual meeting the members of the Exchange elect a president and a treasurer, each for a term of one year, and ten members of a governing committee of forty for a term of four years. We will not delay to consider the election of a nominating committee and its work. The Board of Governers annually appoints from its members a series of standing committees. We have heretofore referred to the Committee on Stock List (Chapter XXXV) and in this chapter to the Committee on Admissions, and may have occasion to refer to other standing committees in the course of our consideration of the Exchange. The Board of Governors annually elects one of its members vice president of the Exchange. It elects a secretary of the Exchange, who also is secretary of the Board and of the standing committees. He holds his position subject to the pleasure of the Board; that is, he is in effect a permanent officer.

GOVERNMENT CONTROL OF STOCK EXCHANGE

For many years the Stock Exchange steadily and successfully resisted efforts to bring it under any governmental supervision. It insisted that its own control over its members through the disciplinary measures of suspension, expulsion, and compulsory arbitration was adequate and more effective than any government control could be. The writer ventures to express his opinion that probably, indeed, fewer abuses of social conduct have taken place on the Exchange proportionally than in other fields of business activity; and that the Exchange as a body has acted vigorously to suppress improper conduct, and at all times has acted to that end as diligently as human inertias ordinarily permit.

Finally, however, the Federal Government enacted the Securities Exchange Act of 1934 (approved June 6, 1934, and amended May 27, 1936). As for the Securities Act of 1933, the administration seized on its jurisdiction over interstate commerce and the mails as a basis for jurisdiction over stock exchanges. It is stated in the preamble of the Securities Exchange Act as follows:

Sec. 2. For the reasons hereinafter enumerated, transactions in securities as commonly conducted upon securities exchanges and over-the-counter markets are affected with a national public interest which makes it necessary to provide for regulation and control of such transactions and of practices and matters related thereto, including transactions by officers, directors, and principal security holders, to require appropriate reports, and to impose requirements necessary to make such regulation and control reasonably complete and effective, in order to protect interstate commerce, the national credit, the Federal taxing power, to protect and make more effective the national banking system and Federal Reserve System, and to insure the maintenance of fair and honest markets in such transactions:

(1) Such transactions (a) are carried on in large volume by the public generally and in large part originate outside the States in which the exchanges and over-the-counter markets are located and/or are effected by means of the mails and instrumentalities of interstate commerce; (b) constitute an important part of the current of interstate commerce; (c) involve in large part the securities of issuers engaged in interstate commerce; (d) involve the use of credit, directly affect the financing of trade, industry, and transportation in interstate commerce, and directly affect and influence the volume of interstate commerce; and affect the national credit.

(2) The prices established and offered in such transactions are generally

disseminated and quoted throughout the United States and foreign countries and constitute a basis for determining and establishing the prices at which securities are bought and sold, the amount of certain taxes owing to the United States and to the several States by owners, buyers, and sellers of securities, and the value of collateral for bank loans.

(3) Frequently the prices of securities on such exchanges and markets are susceptible to manipulation and control, and the dissemination of such prices gives rise to excessive speculation, resulting in sudden and unreasonable fluctuations in the prices of securities which (a) cause alternately unreasonable expansion and unreasonable contraction of the volume of credit available for trade, transportation, and industry in interstate commerce, (b) hinder the proper appraisal of the value of securities and thus prevent a fair calculation of taxes owing to the United States and to the several States by owners, buyers, and sellers of securities, and (c) prevent the fair valuation of collateral for bank loans and/or obstruct the effective operation of the national banking system and Federal Reserve System.

(4) National emergencies, which produce widespread unemployment and the dislocation of trade, transportation, and industry, and which burden interstate commerce and adversely affect the general welfare, are precipitated, intensified, and prolonged by manipulation and sudden and unreasonable fluctuations of security prices and by excessive speculation on such exchanges and markets, and to meet such emergencies the Federal Government is put to such great expense as to burden the national credit.

And therefore:

Sec. 5. It shall be unlawful for any broker, dealer, or exchange, directly or indirectly, to make use of the mails or any means or instrumentality of interstate commerce for the purpose of using any facility of an exchange within or subject to the jurisdiction of the United States to effect any transaction in a security, or to report any such transaction, unless such exchange (1) is registered as a national securities exchange under Section 6 of this title, or (2) is exempted from such registration upon application by the exchange because, in the opinion of the Commission, by reason of the limited volume of transactions effected on such exchange, it is not practicable and not necessary or appropriate in the public interest or for the protection of investors to require such registration.

Further:

Sec. 12 (a) It shall be unlawful for any member, broker, or dealer to effect any transaction in any security (other than an exempted security) on a national securities exchange unless a registration is effective as to such security for such exchange in accordance with the provisions of this title and the rules and regulations thereunder.

Still further:

> Sec. 15 (a) No broker or dealer (other than one whose business is exclusively intrastate) shall make use of the mails or of any means or instrumentality of interstate commerce to effect any transaction in, or to induce the purchase or sale of, any security (other than an exempted security or commercial paper, bankers' acceptances, or commercial bills) otherwise than on a national securities exchange, unless such broker or dealer is registered in accordance with subsection (b) of this section.

So the act covers over the counter markets as well as organized exchanges, and requires (1) a registration of the exchange, (2) a registration of issues dealt in on the exchange, and (3) a registration of brokers and dealers. Since some of the business done on stock exchanges is interstate, the exchange and the issues listed on it must be registered. Since some of the business done by brokers and dealers is interstate, they must register. It seems rather obvious that Congress is casting the net of Federal jurisdiction over interstate commerce to reach matters of contract which are ordinarily the subject only of State authority. In view of this criticism, or corresponding criticism elsewhere in this book, it seems appropriate for the writer to express his belief as to the general desirability of the extension of Federal jurisdiction, in order that he may not be accused of prejudices.

WRITER'S BELIEF AS TO DESIRABILITY OF EXTENSION OF FEDERAL POWERS

So much of our economic activity in its present organized form extends beyond State boundaries that our multiplicity of jurisdictions, each with its own law, seriously hampers our economic life. It is often stated as one of the causes of our general prosperity, as compared with the economic condition of other countries, that we live in so large an extent of territory free from tariff barriers. This conclusion seems a reasonable inference. But we have the barrier to freedom of economic endeavor created by the existence of the Federal and forty-eight State jurisdictions. A contract made in New York to be performed in Illinois requires the consideration of the laws of the two States, and, it may be, also of the law of the Federal Government. The parties cannot prudently contract without examination of all three. And a New York lawyer is rash who undertakes to say what the law of Illinois may be, or indeed, even undertakes to ascertain it, except

through Illinois counsel. When all three laws are ascertained, it is likely to be found that they do not adequately provide for their interrelationship in transactions affected by more than one of them. The number of jurisdictions multiplies the complications of law inherent in the nature of the transaction itself.

In various subjects, notably negotiable instruments and sales, so-called uniform legislation has been promoted. But the statutes of two States may contain the same words, and the courts proceed to different interpretations. Such legislation only palliates.

Lack of uniformity of law creates different conditions for competition in an economic process extending beyond State boundaries.

This is no place to discuss the desirable location of the line between local and national jurisdiction. However, the writer believes that our best economic and social welfare requires a great extension of national powers, so that we may come much nearer to uniformity of law, and to having only one law apply to a much wider range of human activity than is now the case. He further believes that this should take place through amendment to the Constitution, after careful study and consideration of all problems involved, rather than through straining its present clauses.

We will leave further consideration of Federal regulation of the stock exchanges to a later chapter.

DISTINCTION BETWEEN MEMBERS OF THE STOCK EXCHANGE AND STOCK EXCHANGE FIRMS

Only individuals are members of the Stock Exchange. One or more of the partners of a firm engaged in the business of stock brokerage may be a member, or members, of the Exchange. In that event the partnership is called a Stock Exchange firm. The actual relationship with the Exchange, however, is that of the individual partner. No corporation may be a member or a member firm, contrary to the situation existing in commodity exchanges. Only the Exchange member may appear on the floor of the Exchange and transact business there.

Brokerage partnerships having a member who is also a member of the Exchange have an Association of Stock Exchange Firms. Though coöperating with the Exchange, the Association has no official connection with it, but functions essentially as a trade organization.

TYPES OF BROKERS

Stock Exchange brokers divide into several classes according to the type of business they choose. There are commission brokers, specialists, floor traders, and odd lot dealers.

Commission brokers. Only the commission brokers and specialists are strictly brokers. Floor traders and odd lot brokers are really dealers, trading for their own account and carrying the risk of the transaction. Commission brokers act for customers who are part of the general public of speculators and investors. Sometimes such brokers execute orders for each other at a reduced rate of commissions. Only members of the Exchange may transact business on the floor. If the only floor member of a firm is absent for vacation or on account of illness, or if at the moment the volume of orders is too great for the floor man to handle, the firm must put its business through another broker. In that case the broker only executes the order, that is, makes the contract. The firm employing him carries through all the work of completing the transaction.

Specialists. A customer of a commission brokerage firm may give an order to buy or sell when a stock reaches a certain price. Each stock is allocated to its special point or post on the floor where it is dealt in. A broker having an order to execute in a particular stock goes to the post and there finds other brokers who have orders to execute in that stock at that time. But if the broker has an "at price" order, that is, an order to execute when the stock reaches some price different from the current quotation, and should attempt to execute it himself, he would have to stay continuously at the one post to the neglect of all other business. "At price" orders could not be executed under such conditions.

Development of the function of the specialist has made the execution of "at price" orders possible as a part of the organization of the Stock Exchange market. A specialist does not take orders from the general investing and speculating public, but only from other brokers. He does not go from post to post on the floor, but stays continuously at one post, and takes orders only for a stock or stocks dealt in at that post. So he can accept from another broker an "at price" order. Since he is continuously at the post, he knows continuously the course of the market, and can execute the order when the market reaches the price set. As is the case with the commission broker executing orders for another commis-

sion broker, the specialist, when acting as a broker, only makes the contract and receives the reduced rate of commission. The firm giving him the order attends to all the rest of the work of the transaction.

Floor traders. Just as the name indicates, a floor trader makes contracts on his own account on the floor of the Exchange. He may be scalping profits of fractions of a point, and may close out all his transactions on the day they are made. Since he is a member of the Exchange and is executing his own contracts, he has no commissions to pay. If, however, he "clears" his transactions through a firm of which he is not a member, he has, of course, a charge to pay for this service; and if he does not do this, he has the expense of his own office for the purpose.

Odd lot brokers. Though the unit of trading on the floor is the one hundred share lot, with exception of certain issues which may be traded in on smaller lots, the Exchange has developed a process which enables transactions in less than one hundred shares to be made with complete facility. We will later give special consideration to odd lot transactions. It is enough for our present purpose to say that certain firms specialize in fulfilling odd lot orders. In so doing, they are buying or selling on their account.

MEMBERSHIP WITHOUT APPEARANCE ON THE FLOOR

Some memberships in the Exchange are held, not for the purpose of utilizing them by appearance on the floor, but to gain the benefit of the reduced commission of broker acting for a member, and, perhaps, to some extent for the prestige of membership. A great financial and investment banking house may hold a membership through one of the partners, but actually put its floor business through other brokers.

ORGANIZATION OF A COMMISSION BROKERAGE FIRM

The work of a Stock Exchange commission brokerage firm consists of:

Getting business
Executing orders (making contracts)
Clearing transactions (the performance of the contract)
Financing transactions for customers

Business getting is done by the partners and by customers' men.

Executing orders requires the transmission of the order to the broker representing the firm on the floor of the Exchange and utilizes the work of the firm's telephone clerk at the Exchange.

A cashier's department attends to the clearance of transactions, that is, to the performance of the contracts and the various confirmations and notifications involved. Also through the margin clerk it attends to the details of financing customers' transactions. The cashier, in charge of the bookkeeping, confirmations, deliveries, etc., is an important executive of the broker's office.

The actual work involved in the performance of these functions will appear more clearly in the course of our consideration of the Stock Exchange markets.

CUSTOMERS' MEN

Besides whatever contact members of the firm may have with its customers, employees known as customers' men maintain the relationships of the brokerage office with investors and speculators who do business through it. A customers' man obtains his position by reason of his probable ability to command business. Rules of the Exchange prohibit compensating him in the form of commissions. But, as in other business-getting employment, the firm will base his salary largely on his productivity.

He confers with his customers when they come into the office, takes their orders, and puts them in course of execution. He takes the customers' telephone calls and initiates telephonic communication to the extent desired by the customer. One customer may depend largely on the opinions of the customers' man through whom he deals; another may utilize his services merely as a conduit for the execution of orders. A personality which customers like is probably the first of the qualifications of this employee; but a knowledge of securities and a sense of the market will greatly assist him in the retention of customers. Though the firm makes its living directly, and the customers' man indirectly, on the volume of trading, the pressure put on the customer to trade is much less than it used to be. There seems to be recognition on the part of Exchange brokers that such pressure is not good business in the long run; and probably in most offices today a customer will not be conscious at all of any pressure to trading.

CHAPTER L

Relations of Broker and Customer

Superficially simple, the relationship of stockbroker and customer, on analysis, shows complexity.

It is more susceptible of misunderstanding and errors than the situation of depositor and bank.

An investor or speculator opening an account with a New York Stock Exchange firm has the presumption of integrity raised by the very fact of membership in the Exchange. He may, nevertheless, feel that there is a preference among firms arising out of reputation for honor and financial ability, as well as from the usual matters of likes and dislikes of personalities.

When he opens a bank account, the bank statement is available to him as a basis for opinion on the bank's soundness. To be sure, this does not go very far in the absence of a list of the asset items in the portfolio, which is not available to the depositor, and if it were, would require a knowledge of the credit of each item. However, he knows that the bank is subject to the periodical visits of a bank examiner, and may reasonably believe that the statement of the value of the assets has at least some substantial basis of credibility.

He does not have a financial statement to go on when selecting a broker. The affairs of the firm are subject to some supervision by the Exchange. The customer must rely on this, and on general reputation. Yet he will be entrusting substantial assets, very likely of much greater amount than his usual bank balance, to the possession and control of the brokers. Their failure might cause him a much greater loss than the failure of his bank.

On the other side the broker needs to be more cautious in accepting a customer and opening an account than a bank in accepting a depositor. In the ordinary course of business, orders may be given over the telephone. Quite aside from the danger of misunderstandings arising out of such a form of communication, the

unscrupulous customer may welsh, may deny that he gave the authority he did in fact give. Though a man with sufficient cash or collateral in hand probably does not find it very difficult to open a brokerage account, the brokerage firm is likely to desire some introduction tending to indicate that the prospective customer is a reputable member of the community.

INVESTMENT ACCOUNTS AND MARGIN ACCOUNTS

In considering the relationship of broker and customer, we need to recognize the difference between margin accounts and investment accounts. The customer may be prepared to finance all his commitments himself, that is, to pay for them outright, in full. If that is the case, the relationship of broker and customer becomes simple. For convenience in further transactions the customer may not have the purchased stock transferred into his own name, but be content to leave it in the form of a street delivery; or, if it is dividend paying, transferred into the name of the broker and the certificates left in the custody of the broker. In that case the broker collects the dividends and credits them to the customer's account. But the broker has no right to deal in any way with the stock except on his customer's express authority. The certificates are known as "box securities." The broker must keep them in his own safe deposit box free for immediate delivery to his customer on demand.

Most brokerage accounts, however, do not have this simplicity. The customer expects the broker to finance, in part, the transactions. In this case the broker has more than mere custody of the certificates. He has a lien on the stock as security for his advances to the customer. The relationship of pledgor and pledgee arises. We have said something of this in Chapter XXXV on secondary markets. But we now need to go further into the matter.[1]

[1] It should be remarked that the law of Massachusetts, and perhaps of some other jurisdictions, has not treated the relationship as that of pledgor and pledgee, but as giving rise to mere contract rights for the delivery of stock. That is, the broker has received from his customer part of the purchase price of shares which the broker contracts to buy, and to deliver to the customer on receiving the rest of the purchase price. The broker advances the further funds required for the transaction, and the customer is liable for this amount on the contract. The customer has no property interest in any particular shares, and the broker is in breach of contract but not violation of the fiduciary relationship of pledgee if he fails to deliver.

RIGHTS OF PLEDGOR AND PLEDGEE

It may be taken as a general principle of the relationship of pledgor and pledgee that the pledgee must keep himself in a position to deliver the pledged collateral to the pledgor who is ready to repay the loan. This precludes the pledgee from dealing with the collateral in any way derogatory to such a position. The pledgee does have a right to repledge, but not to repledge under any conditions that would interfere with the pledgor procuring possession of the collateral when he is ready to repay the loan.

Let us assume that a broker has advanced $5000 on behalf of his customer to pay in part for one hundred shares of XY stock which he has bought on the customer's order for $100 a share, for the purchase of which he already holds $5000 of the customer's funds. The transaction with respect to the loan we assume is on demand; the broker has a right at any time to call upon his customer to pay off the loan; the customer has a right at any time to pay off the loan and get delivery to him of the certificate properly endorsed so that he can transfer it into his own name.

The broker may utilize the stock as collateral for a demand loan to him for $5000 or less. However, unless especially agreed to the contrary, the loan must be separate and distinct from other loans to the broker; so that the customer, by paying off the $5000, which is no more than the amount he owes the broker, can certainly get his security into his own possession.

It is obvious that if the broker should take this stock and stock in like amounts of, say, nine other customers, and pledge all these items of collateral with a bank for a single loan for $50,000, the customer would not be able to get his hundred shares into his own possession on paying $5000; unless, indeed, the broker had expressly stipulated with the bank that it would release the one item of stock on receiving part repayment of the loan to the extent of $5000. That is, if a broker, without express consent of customers, commingles their securities in utilizing them as collateral for a single loan to him, he commits a breach of a duty he owes to the customer.

Arising out of the known custom of brokers, it is generally sufficient for the broker to have on hand an amount of stock of the kind belonging to, and available for, the customer. That is, the broker is not obliged to retain the identical certificate, or to keep the certificate in the customer's name. Indeed, a broker who

should buy stock on his customer's margin and have it transferred into the customer's name might find himself in a very embarrassing position. If the customer refused to endorse the certificate after its purchase and should fail to pay the amount he owes the broker, the broker would not then have a certificate which would be a good delivery on a sale of the collateral. In the case of a non-dividend paying stock the broker may keep the street delivery certificate in the form in which he received it. In the case of a dividend paying stock he will have the certificate transferred into his own name.

What if the broker utilizes this customer's certificate by lending it to another broker who borrows it for delivery on a short sale by his customer? We will later fully consider the process of a short sale. For our present purposes it is enough to say that the broker who borrows the certificate pays to the lending broker the full market value of the stock, and contracts to redeliver a certificate for an equal number of shares on receiving back the funds that he has paid. Since the amount of funds that will have to be paid to recover a certificate is the full market value of the stock, it is obvious that this amount would ordinarily be in excess of the amount the broker has loaned his customer. Under these circumstances the broker lending his customer's certificate would not have stock in his possession, and the customer, on tender of the amount of his debt, would not have the right to get the particular shares loaned.

Customers have further rights arising out of the pledgor-pledgee relationship. So far we have been concerned with their right to get their stock on their payment of indebtedness to the broker. What if they do not fulfil their obligation to repay? The broker has a pledgee's lien on the stock, a right to sell the shares and apply the proceeds to or towards the satisfaction of the debt, paying to the customer any surplus that may arise on the sale. But, in the absence of special agreement, the broker does not have a right to do this except under specific conditions which afford protection to the customer. In foreclosing the pledgee's lien, the broker must give the customer such notice of the time and place of sale as the law requires. And the place must be public. The customer must have access so that he may have one last chance to protect himself by bidding at the sale. Anyone else must have access so that those interested in bidding may, perchance, increase the price. Since only members of the Stock Exchange are ad-

mitted to its floor, that is not a public place. For securities listed there it may be the best market. But the law provides for all transactions, and makes no exception for listed securities.

WAIVERS

Conditions of the brokerage business are such that it could not be carried on in its present form and observe all the requirements we have just considered. It would be impracticable for brokers to borrow from their banks on separate loans on the securities of each customer as collateral. Prices change rapidly, and sometimes vary widely within a short time. If the broker had to give the customer the full legal notice required by law, the collateral might decline greatly in value before the sale could be made. To be sure, the broker would still have the personal liability of the customer for the deficiency; but the responsibility of a customer who has let his collateral go to sale is not likely to be satisfactory.

Since nothing prohibits a customer from waiving these various rights, a waiver is effective to cut them off. So a broker puts himself in a position to conduct a margin account by requiring a customer, on opening an account, to execute such a waiver. It may authorize the broker: to pledge the customer's securities for loans greater than the amount due from the customer; to mingle the customer's securities with the securities of others as collateral for a loan to the broker; to loan the certificate for delivery on a short sale; to pledge the security for a loan on time or demand; to sell with or without demand for repayment and notice of the time and place of sale; to sell on the Exchange. To include the short sale the waiver may authorize the broker to buy in without demand or notice of time and place, and to buy on the Exchange. With an adequate waiver signed by the customer the broker is in a position to carry on a margin account.

The New York Penal Law has a section (956) dealing with the matter:

> A person engaged in the business of purchasing and selling as a broker stocks, bonds or other evidences of debt of corporations, companies or associations, who
>
> 1. Having in his possession, for safe keeping or otherwise, stocks, bonds or other evidences of debt of a corporation, company or association belonging to a customer, without having any lien thereon or any special property therein, pledges or disposes thereof without such customer's consent; or

2. Having in his possession stocks, bonds or other evidences of debt of a corporation, company or association belonging to a customer on which he has a lien for indebtedness due to him by the customer, pledges the same for more than the amount due to him thereon, or otherwise disposes thereof for his own benefit, without the customer's consent, and without having in his possession or subject to his control, stocks, bonds or other evidences of debt of the kind and amount to which the customer is then entitled, for delivery to him upon his demand therefor and tender of the amount due thereon, and thereby causes the customer to lose, in whole or in part, such stocks, bonds or other evidences of debt, or the value thereof,

Is guilty of a felony, punishable by a fine of not more than five thousand dollars or by imprisonment for not more than two years, or by both.

Every member of a firm of brokers, who either does, or consents or assents to the doing of any act which by the provisions of this or the last preceding section [1] is made a felony, shall be guilty thereof.

NOTIFICATION TO CUSTOMER OF TRANSACTIONS

A customer is entitled to information about his broker's execution of an order. In actual practice brokers regularly send the customer such a notice. As phrased in the New York Penal Law (Section 957):

A person engaged in the business of purchasing or selling as broker stocks, bonds and other evidences of debt of corporations, companies or associations shall deliver to each customer on whose behalf a purchase or sale of such securities is made by him a statement or memorandum of such purchase or sale, a description of the securities purchased or sold, the name of the person, firm or corporation from whom such securities were purchased, or to which the same were sold, and the day, and the hours between which the transaction took place. A broker who refuses to deliver such statement or memorandum to a customer within twenty-four hours after a written demand therefor, or who delivers a statement or memorandum which is false in any material respect, is guilty of a misdemeanor, punishable by a fine of not more than five hundred dollars, or imprisonment for not more than one year, or both.

The writer is of the impression that brokers do not customarily put the hour of the transaction on their notifications to customers, but state that the information will be given the customer on his request. The matter does not become penal until after demand is made. Records of the broker show the hour, and

[1] Deals with transactions by brokers after insolvency.

he could supply it on demand. Such a memorandum of the transaction would enable the customer to check on the fidelity of the broker. The list of sales on the Exchange is published daily. The price should fall within the range of the day. Moreover, the suspicious customer who should sue his broker in the belief that the broker had not made any such transaction, in short had "bucketed" the order, or that he had not correctly reported it, would know where to seek evidence.

PROVISIONS OF THE SECURITIES EXCHANGE ACT

The law (Section 8) provides that:

It shall be unlawful for any member of a national securities exchange, or any broker or dealer who transacts a business in securities through the medium of any such member, directly or indirectly ***

(c) In contravention of such rules and regulations as the Commission shall prescribe for the protection of investors to hypothecate or arrange for the hypothecation of any securities carried for the account of any customer under circumstances (1) that will permit the commingling of his securities without his written consent with the securities of any other customer, (2) that will permit such securities to be commingled with the securities of any person other than a bona fide customer, or (3) that will permit such securities to be hypothecated, or subjected to any lien or claim of the pledgee, for a sum in excess of the aggregate indebtedness of such customers in respect of such securities.

(d) To lend or arrange for the lending of any securities carried for the account of any customer without the written consent of such customer.

RELATIONSHIP OF BROKER'S CAPITAL TO LIABILITIES

While we are noticing the problem of rehypothecation of customer's securities, we may appropriately mention another provision of the Securities Exchange Act, requiring a broker who is a member of a national securities exchange, and incurs debtor liabilities, to have some capital besides his seat on the exchange and his office furniture. Section 8 (b) makes it unlawful for him:

To permit in the ordinary course of business as a broker his aggregate indebtedness to all other persons, including customers' credit balances (but excluding indebtedness secured by exempted securities), to exceed such percentage of the net capital (exclusive of fixed assets and the value of Exchange membership) employed in the business, but not exceeding in any case 2000 per centum, as the Commission may by rules and regula-

tions prescribe as necessary or appropriate in the public interest or for the protection of investors.

"Exempted securities" are essentially securities of the United States and of States and municipalities in the United States.

The reason for excluding the value of the exchange membership in the computation of broker's capital has appeared in our discussion of the preference as to this asset which the constitution of the exchange creates in favor of exchange members. This preference reduces its value as security to customers.

The debtor-creditor relationship of broker and customer, which exists in addition to that of pledgee-pledgor, tends to approximate that of bank and depositor. A broker, as such, may not engage in the business of banking. He may not turn his customer's credit balance into a deposit account to be paid to others than the customer on the order of the customer. But a customer regards his credit balance as a very liquid asset to be drawn upon by him up to the limit of the broker's margin requirement. A broker's ratio of capital (other than the value of his seat) to liabilities of one-twentieth of one per cent, or five cents on the hundred dollars, seems hardly an excessive requirement.

RELATIONSHIP OF BROKER AND CUSTOMER WITH RESPECT TO VOTING CUSTOMER'S SHARES

As a general principle the pledge of stock does not destroy the pledgor's right to vote it. But we have seen that it is customary for a broker, at least in the case of dividend paying stock, to transfer the shares into his own name. And, as we have seen, the corporation takes cognizance only of its record list of shareholders. The provision of the New York Stock Corporation Law relating to the situation (Section 47) is:

> Except in cases of express trust, or in which other provisions shall have been made by written agreement between the parties, the record holder of stock which shall be held by him as security or which shall actually belong to another, upon demand therefor and payment of necessary expenses thereof, shall issue to such pledger or to such actual owner of such stock, a proxy to vote thereon.

Though this would require the broker, carrying in his own name stock of the customer, to give a proxy to the customer on the customer's demand, it would not prohibit the broker from voting the

stock when a proxy had not been demanded of him. Some criticism arose of the voting of customers' stock by brokers, or of brokers giving proxies to the corporate management, and it became the practice for brokers to procure the express consents of their customers.

PROXIES

Though the provisions of the Securities Exchange Act relating to the solicitation of proxies refer only in part to the relationship of broker and customer, we will consider them at this point. The law (Section 14) provides:

(a) It shall be unlawful for any person, by use of the mails or by any means or instrumentality of interstate commerce or of any facility of any national securities exchange or otherwise to solicit or to permit the use of his name to solicit any proxy or consent or authorization in respect of any security (other than an exempted security) registered on any national securities exchange in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

(b) It shall be unlawful for any member of a national securities exchange or any broker or dealer who transacts a business in securities through the medium of any such member to give a proxy, consent, or authorization in respect of any security registered on a national securities exchange and carried for the account of a customer in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

However, the regulations issued under this section exempt brokers from the requirements made of non-exempted persons in the solicitation of proxies. They provide (Rule LA2):

The rules and regulations promulgated by the Commission pursuant to Section 14 of the Securities Exchange Act shall not, except where specifically so provided, apply to solicitations (a) by any bank, dealer, broker or nominee in respect of securities carried in its name where no commission or remuneration is paid directly or indirectly to it for such solicitation, (b) by any custodian in respect of securities held in its custody where no commission or remuneration is paid directly or indirectly to it for such solicitation, (c) by any trustee, other than a voting trustee or trustee of a business trust, in respect of securities of which he is trustee, (d) by any person in respect of securities of which he is the beneficial owner, or (e) by any person whose activity is limited to the performance of ministerial acts in behalf of a person who is soliciting a proxy, consent or authorization.

COMMISSIONS

For many years the standard basic commission on the Exchange was $12.50 a hundred shares for buying or for selling, which is one-eighth of a point. A speculator could compute that on making a commitment the market would have to change three-eighths of a point before he could close without loss. That is, to complete the transaction he would have to pay a buying and a selling commission of an eighth each, and on initiating the closing transaction he would probably have to accept an eighth lower on a sale or pay an eighth higher on a purchase.

With the general change in the price level the Stock Exchange some years ago advanced its average rates of commission. The rate now depends on the price of the shares. At the present time (January, 1938) the rates are as follows on one hundred share lots:

Price of Stock	*Rate Per Share*
$\frac{1}{256}$ of $1	0.1¢ per share
$\frac{1}{128}$ of $1	0.15¢ per share
From $\frac{1}{64}$ of $1 to $\frac{1}{16}$ of $1	0.5¢ per share
From $\frac{3}{32}$ of $1 to $\frac{7}{32}$ of $1	1.0¢ per share
From $\frac{1}{4}$ of $1 to $\frac{15}{32}$ of $1	1.5¢ per share
From $\frac{1}{2}$ of $1 to $\frac{31}{32}$ of $1	3.0¢ per share
From $1 to 1\frac{7}{8}$	5.0¢ per share
From $2 to 2\frac{7}{8}$	6.0¢ per share
From $3 to 3\frac{7}{8}$	7.0¢ per share
From $4 to 4\frac{7}{8}$	8.0¢ per share
From $5 to 5\frac{7}{8}$	9.0¢ per share
From $6 to 6\frac{7}{8}$	10.0¢ per share
From $7 to 7\frac{7}{8}$	11.0¢ per share
From $8 to 8\frac{7}{8}$	12.0¢ per share
From $9 to 9\frac{7}{8}$	13.0¢ per share
From $10 to 19\frac{7}{8}$	14.0¢ per share
From $20 to 29\frac{7}{8}$	15.0¢ per share
From $30 to 39\frac{7}{8}$	16.0¢ per share
From $40 to 49\frac{7}{8}$	17.0¢ per share
From $50 to 59\frac{7}{8}$	18.0¢ per share
From $60 to 69\frac{7}{8}$	19.0¢ per share
From $70 to 79\frac{7}{8}$	20.0¢ per share
From $80 to 89\frac{7}{8}$	21.0¢ per share
From $90 to 99\frac{7}{8}$	22.0¢ per share
For each additional $10 or fraction thereof	1.0¢ additional

CHAPTER LI

Execution of an Order

We assume now that the customer has signed the required waiver discussed in the preceding chapter, has placed the broker in the amount of funds estimated to be required for margin for the immediate future, has furnished his specimen signature and his address for notices and other communications. The account is opened. He signs one of the broker's purchase tickets to buy one hundred shares of XYZ common "at market." That is, the order is to be executed as promptly as possible at the price obtainable at the time.

FLOOR OF THE EXCHANGE

In order to understand the course of the execution of the order, we need to know something more of the layout of the floor of the Exchange. We have already seen that each stock is assigned to one of the various "posts." But we have not considered the course of communication of an order from the broker's office to the member on the floor. He alone can execute the order, and he may be anywhere on the floor at any time. Around the walls of the trading room a spectator in the visitors' gallery may see a series of deep alcoves, somewhat reminiscent of *cabinets particuliers* around the floor of a restaurant. In the Stock Exchange alcoves, however, instead of seats along the cabinet partitions there are shelves breast high, with lines of telephone instruments, before which men are standing, and there is no equivalent of the restaurant table. The men are "telephone clerks," and are not employees of the Exchange, but of the various Stock Exchange firms. They are a human link in the chain of communication between the office of the firm and its representative on the floor.

So we trace readily the transmission of the customer's order over the telephone to the telephone clerk in one of the alcoves open to

the floor. He must get the order to the mind of the floor member. Our visitor in the gallery sees at each end of the trading room what looks like a huge blackboard divided into many small rectangles. From time to time a number flashes in one of the rectangles. Each member has his official Exchange number and keeps an eye on the signal board to see if he is being signaled. The telephone clerk can get the attention of the member by flashing his number on the board, whereupon the member can communicate with his clerk personally or by sending one of the floor pages. Or it may be the clerk knows the whereabouts on the floor of the member and can utilize one of the numerous pneumatic tubes which run everywhere through the Exchange, to send the message to the member at one of the posts.

During the trading the floor looks disorderly. The crowd there appears to the onlooker in the gallery to have no organization of its activity. So a hive of bees looks to one who ventures to peer in. Some of those on the floor are in the Stock Exchange uniform. They are Exchange employees and are either pages or reporters. As already indicated, the pages are for the transmission of messages on the floor. The reporters need a word of explanation.

TICKER SYSTEM

Most people are familiar with the stock ticker. Some see it in actual operation in brokers' offices. Many more see it as one of the properties in a screen depiction of some "drama of finance." The quotations it publishes have to get on the tape in some way. The first link in the chain of transmission is the reporter, the next the floor operator. Our onlooker will notice a man in Stock Exchange uniform in each group of brokers. He notes the amount and price of each transaction and furnishes it to the nearest of the four operators of transmission instruments.

MAKING THE CONTRACT

When the member receives his "at market" order he proceeds to the post at which the stock is dealt in. He finds assembled there other brokers who have orders in the same stock to execute. Our broker may note the price of the latest transaction posted; he may hear a bid made and accepted. He can wait for an offer of the stock to be made, or can himself make the offer. We will

Of course the deliver and receive tickets should correspond and present identical information. Each ticket is an adequate memorandum of the contract and is signed by the party to be charged. Such an exchange of tickets reduces the contract to a written form.

If the tickets do not correspond, the respective brokers must iron out the difference. On their failure to agree the matter must go to the Arbitration Committee of the Exchange. Pending settlement the brokers may liquidate the damages by purchase, sale, or agreement.

The tickets are in the form of orders on the Stock Clearing Corporation (Night Clearing Branch) to receive and to deliver the shares the contract calls for. The reason for this form will appear in our consideration of the clearance process. Here we are concerned only with the comparison, the reduction of the contract to written terms showing that the parties are in fact in agreement. Each house must deliver to the Distributing Department by 4:20 P.M. of the day of the contract the exchange tickets it has received from the brokers with whom it has dealt.

We will note that the ticket the seller makes out has a detachable part. The seller affixes the transfer tax revenue stamps to this part and retains it, so that he may produce it as evidence to the Federal and State taxing authorities of the payment of the tax.

If the stock is not an issue admitted to clearance, the seller makes out a ticket in triplicate, and sends it to the buyer's office, which, through the Distributing Department, returns the other two copies to the seller.

We are not attempting to go into this matter of comparisons in detail, but are presenting just enough to show the reduction of the oral contract made on the floor of the Exchange to the form of a written memorandum.

KINDS OF CONTRACTS AND THEIR PERFORMANCE

Performance of the contract involves delivery of the stock by the seller and payment by the buyer.

Unless the contract otherwise provides, performance is by "regular way" on the second full business day following the day of the contract (except that contracts for United States Government bonds are for delivery on the next full business day). So a con-

tract made Wednesday would be for delivery and payment on Friday, but one made Thursday would not be performed until the Monday following. When the day of performance arrives, delivery must be made before 2:15 P.M.

However, the contract may be one of several other recognized types. It may be for "cash." In that event the seller must deliver on the very day of the contract. Cash transactions do not clear through the Stock Clearing Corporation. If the contract is made on the floor before 2 P.M. on a full business day, the delivery must be made before 2:15. Deliveries against contracts for cash made on or before 11:15 A.M. on a half holiday are due before 11:30 A.M. If the contract is made after 2 P.M. on a full business day or after 11:15 A.M. on a half holiday, delivery is due within thirty minutes after the time of the contract. The reader should note that the term "cash contract" as used in Stock Exchange transactions means something a little different from its ordinary meaning. All Stock Exchange transactions are for cash in the sense that delivery and payment are simultaneous.

A contract may be at "seller's option," that is, for delivery at the option of the seller, within the time specified in the option. The time, however, must be not less than three days nor more than sixty days from the day of the contract. The seller must make delivery on the day ending the period, and he may make it on any full business day prior thereto on one day's written notice, which must be given before 4 P.M. on a full business day, and before 1 P.M. on a half holiday, but may not be given until the second full business day following the day of the contract.

An issue may be listed on the Exchange and dealt in on a "when issued" basis. In that case the Committee on Securities determines the delivery day.

Rules just indicated are for stock transactions. In the case of bonds the seller may state that they are sold for delayed delivery. Then the delivery may be on the seventh day following the day of the contract.

Only enough of the delivery rules has been given to indicate the general course of transactions. Deliveries of all stocks, whether admitted to clearance or not, and of all clearance bonds, are made through the Central Delivery Department of the Stock Clearing Corporation, and we will defer further consideration of this process to a chapter on the work of that adjunct to the Exchange.

DAILY SETTLEMENT

Continental bourses and the London Stock Exchange have fortnightly settlements. Contracts are made through a two weeks period for performance by delivery and payment at the end of the two weeks period. As we shall see when we come to consider our process of settlement by clearance, this overseas process reduces the work of delivery and the amount of financing involved.

Our process of settlement has the salutary effect of the daily check on solvency. Each broker knows that on the purchase contracts he makes today he will have to stand the test of meeting payment on the second full business day after the contract. He knows that the broker to whom he has sold stock likewise contracts with a knowledge of the early payment day. Under the overseas plan a broker on the edge of insolvency, or already insolvent, may speculate more wildly in the hope that the course of the market may restore him to solvency before the settlement day. The greater safety of our process of daily settlement seems well worth the extra work. Extension of the functions of the Stock Clearance Corporation has greatly reduced this work, as we shall see, and increased efficiency.

ORDERS OTHER THAN "AT MARKET"

Though mention has been made of "at price" orders, our consideration of orders and the execution has been limited to "at market" orders. By the intervention of the specialist the Exchange has worked out a method by which "at price" or "stop loss" orders may be handled.

Let us assume that a speculator has made up his mind to close out a transaction when the quotation on the stock reaches a certain price. He may want to limit his loss. That is, he may say to himself that he is prepared to lose three points on a hundred shares, or $300, taxes and commissions, but is not willing to chance further loss. If he buys the stock at 85, he wants to sell at 82; if he has sold short at 85, he wants to cover at 88. In either case, on closing at these prices, he will have limited his loss to the amount that he is prepared to suffer.

So (assuming that he has bought the stock) he places an order to sell at 82. Unless indicated to the contrary, this will expire with the day. Since he wants to keep the order in effect he marks

it G.T.C. (good till canceled, or countermanded). Or he may mark it G.T.M. (good this month), or G.T.W. (good this week).

Correlatively, he may desire to take his profit when the stock reaches a certain point. The process of the "at price" transaction is the same.

Such an order, entrusted by the customer's broker to a specialist, will be executed in an ordinary market at the price set, provided that price is reached. In a disorderly market the price might not change by the usual eighths, but by larger fractions, and even whole points. Once the market reaches the set price, it is the duty of the specialist to execute the order on the best terms he can make. However, usually these stop orders reach execution at the price set, or only an eighth or a quarter away, with automatic precision. Speculators rely on them, and on our Exchange do not utilize "options" as hedges against loss as much as speculators on the foreign exchanges.

STOCK OPTIONS

There are people who make a business of dealing in options on stock. A stock option is a contract to buy or to sell, within a stated period, a stated number of shares of a stock, at the contract price. If our speculator who has bought one hundred shares of XY common at 85 wished to utilize this means of protecting himself, he might buy a seven-day option to sell the one hundred shares at 82. At any time within the seven-day period he can then call upon the option dealer to take the one hundred shares at that price. So he is protected for that time against a fall in the market below 82. If the market does not decline to 82 within the period, the speculator will not utilize the option, and he will have lost the price he paid for it. The seller of the option is bound to deliver or take delivery, when called on within the time limit to do so, but the buyer of the option is free to act as his interests dictate.

Obviously a speculator may utilize such an option as an independent means of speculation. If he buys the option without already being the owner of the shares he desires to protect, and, within the time, the price of the stock goes sufficiently below 82, he can buy the stock in the market at the market price and call upon the option dealer to take it at the option price. The difference between the cost of the shares and the option price may be

enough to cover the cost of the option, the commission and tax expense, and leave a profit. He has utilized an option to speculate for the fall. Such an option to require the dealer to take stock is denominated a "put."

Our speculator may be short, and desirous of hedging his position. Or he may believe the market will advance, and desire to utilize an option as a means of speculating for the rise. In that case he can buy an option, good, say, for seven days, under which the dealer agrees to deliver the stated number of shares at, say, 88. We are assuming that the market at the time of making the option contract is 85. If the stock does not pass 88 within the period, the speculator has lost what he paid for it; but if the stock goes above 88 he will require the dealer to deliver the stock which he can sell at the higher price on the Exchange. Such an option is described as a "call." If the speculator is short in the market, he can utilize it as a hedge.

It is even possible to combine the two options, so that the speculator may buy a single option giving him the right, within the time limited, to "call" for the stock at 88 or to "put" the stock at 82. Such an option is called a "straddle."

Under the regular course of trading in these options, a Stock Exchange firm guarantees the dealer's performance of his contract.

The cost of the option per share naturally depends on (a) the length of time within which it may be exercised; (b) the spread between the current market price and the option price; (c) the state of the market, i.e., whether it is fluctuating widely or is steady. The longer the time, the greater the chance of price change; the narrower the spread, the greater the chance that the market price will pass the option price; and the steadier the market, the less the chance.

WORK OF THE SPECIALIST

A reader of the Securities Exchange Act notes the provision [Section 11 (b)] that:

> When not in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors, the rules of a national securities exchange may permit (1) a member to be registered as an odd lot dealer and as such to buy and sell for his own account so far as may be reasonably necessary to carry on such odd lot transactions, and/or (2) a member

to be registered as a specialist. If under the rules and regulations of the Commission a specialist is permitted to act as a dealer, or is limited to acting as a dealer, such rules and regulations shall restrict his dealings so far as practicable to those reasonably necessary to permit him to maintain a fair and orderly market, and/or to those necessary to permit him to act as an odd lot dealer if the rules of the exchange permit him to act as an odd lot dealer. It shall be unlawful for a specialist or an official of the exchange to disclose information in regard to orders placed with such specialist which is not available to all members of the exchange, to any person other than an official of the exchange, a representative of the Commission, or a specialist who may be acting for such specialist; but the Commission shall have power to require disclosure to all members of the exchange of all orders placed with specialists, under such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors. It shall also be unlawful for a specialist acting as a broker to effect on the exchange any transaction except upon a market or limited price order.

For the present we are not concerned with the reference to the odd lot dealer excepting as it appears in connection with the specialist. The significance of this provision of the statute arises out of the fact that, by the development of custom on the Exchange, specialists act both as dealers on their own account and as brokers. The two functions may conflict. It is the duty of a broker to get the best price possible for his principal. If the broker has sales or purchases to make on his own account, he must not make them in any way in derogation of the interests of the principals for whom he acts. So if he has an order to sell XY common at 85, he must execute this order before he sells his own stock when the market reaches a point at which a sale can be made at this price. Rules of the Exchange provide that he must so conduct himself.

If the specialist were prohibited from dealing on his own account, no conflict of interest could arise. However, part of the attraction to a member to be a specialist has been the opportunity afforded to combine the functions of a broker's broker and those of a floor trader and odd lot dealer within the limitations of the stocks in which he acts. In view of the highly important part specialists have come to perform in the organized trading on the Exchange, a decrease in their number might lower the efficiency of the market.

A correlated matter is the information contained in the order

book of the specialist. For his stocks he knows the "at price" orders he has. If there is an accumulation of preponderantly selling orders around any given figure, their execution will affect the market. The specialist as a dealer can act accordingly for his own benefit, and the effect of his action may be unfavorable to some of the principals for whom he has orders. There seems to be no way of avoiding this possibility as long as the specialist has a right to trade on his own account, unless, indeed, the contents of the order book are known to all brokers, who can advise their customers accordingly. That action has not been taken. The specialist, however, has been forbidden to disclose the orders on his book and so give to another the advantage which a knowledge of these orders affords. Before the Commission was established the rules of the Exchange forbade showing the "book" to one without making it available to all.

COMMISSION BROKERS SPECULATING ON THEIR OWN ACCOUNT

The Securities Exchange Act [Section 11 (e)] directed the Commission "to make a study of the feasibility and advisability of the complete segregation of the functions of dealer and broker," and to report to Congress.

One of the reasons why such a segregation would be desirable arises out of the almost banking relationship of broker and customer. A broker has control of the securities of his customers who are trading on margin. And, as we have seen, a customer who buys outright may for convenience leave his securities in the possession of the broker. An investment customer has at all times a right of immediate possession of his securities. Brokers are under a duty to deliver securities to margin customers when the customers pay the balances they owe.

In the event of an insolvency of a broker, the customer wants the securities themselves, not a claim in bankruptcy for damages because of failure of the broker to deliver. The securities are worth a hundred cents on the dollar of their market price. A damage claim will be liquidated at whatever number of cents on the dollar the insolvent estate pays out to unsecured creditors. Consider a hypothetical specific case. A customer bought one hundred XY common at 90 on a fifty per cent margin. So the cost was $9000. The customer paid $4500, and the broker car-

ried him for the balance of $4500. The broker became insolvent. Now XY common sells at 80. By paying $4500 the customer has a right to a certificate for stock now worth $8000, or a net value of $3500. Let us assume that the bankrupt estate of the broker will liquidate at sixty cents on the dollar of unsecured claims. If the customer cannot identify his stock, i.e., find shares in the possession of the broker which the customer can prove directly or inferentially belong to him, he must pay his debt of $4500 and has a claim for its value of $8000. At sixty cents on the dollar the value of the claim is $4800, with a net result that the customer salvages $300 out of the situation as compared with the value of $3500 he would have if the broker held the number of XY common shares he ought to have.

Quite aside from intentionally wrongful dealing, the affairs of a man struggling on or over the edge of insolvency are likely to get out of order. And the pressures are strong to take chances. Whether arising from intent or from negligence, an insolvent firm may not have on hand the shares it ought to have.

A broker who does not add the hazards of his own speculation to the other hazards of his business is less likely to become insolvent than a broker who does speculate on his own account.

ODD LOT BUSINESS

Standard transactions on the floor of the New York Stock Exchange are for lots of one hundred shares and multiples. Formerly all contracts between brokers acting for two principals were on that basis; latterly, however, trading in certain issues has been permitted in less than one hundred share lots.

Nevertheless, for any issues, "odd lots," as less than one hundred shares are called, can be bought and sold on the Exchange as readily as lots of one hundred shares, and constitute a substantial part of the total dealings.

ODD LOT DEALERS

Odd lot dealers supply the mechanism through which the business is done with facility.

If all issues were open to regular trading in any amounts from one share up and a customer should instruct his broker to buy ten XY common, the broker might not be able immediately to find a

fellow member entrusted with an order to sell ten shares of XY common. The odd lot dealer, making sales and purchases on his own account, stands ready at all times either to buy or sell the less than one hundred share lot.

RESEMBLANCE TO LONDON JOBBERS

In this respect of readiness to buy or sell shares of a given issue at any time, an odd lot dealer performs the function of a "jobber" on the London Exchange. A jobber stands ready to "make a market" in certain issues in which he holds himself out as a jobber. On that Exchange a broker with a customer's buying or selling order does not seek out another broker with a correlative selling or buying order, but seeks a jobber in the issue. Assume the issue is AB Preference shares. The broker asks the jobber to quote on one hundred AB Preference, and the jobber quotes $86\frac{1}{2} - 87$. Such a quotation is a bid and asked price. The jobber offers to buy one hundred shares at $86\frac{1}{2}$ and to sell one hundred at 87. The broker then discloses whether he is buying or selling, and accepts one or the other offer as the case may be.

On the New York Exchange the odd lot dealer knows whether the broker is buying or selling, and makes a price in accordance with the market. In fact the conventions as to price are so established that the transaction amounts to filling an order. Price conventions permit limited price orders in odd lots as well as in one hundred share units; and odd lot orders at limited prices are freely given.

SPECIALISTS AS ODD LOT DEALERS

Specialists may deal on their own account as well as execute orders for brokers. In the early development of the Exchange they did all the odd lot business, and they still do some. But large, elaborately organized firms making the business their main occupation do the vast mass of it. Each has a substantial number of representatives on the floor. The firm, as an organization, does business in the entire list, and in this respect differs from the London jobber, who limits himself to certain issues, like a specialist on the New York Exchange. The odd lot firm's individual representatives on the floor can cover the issues dealt in at a particular post. The number of floor members of each firm facilitates the filling of orders.

ODD LOT TRANSACTION

From broker's office to telephone clerk in the booth at the Exchange the order follows the same course as one for one hundred shares. And, just as for a hundred share order, the clerk may transmit the order to the firm's floor man. But more likely he will transmit it by pneumatic tube directly to the representative of the odd lot house covering the trading post, and he will fill the order in accordance with the price conventions, and notify the clerk.

An odd lot house may be either long or short of a given stock. In that case its odd lot sales simply liquidate its long position, or its purchases cover its short position. Otherwise it accumulates its odd lot purchases until it has one hundred shares, when it may sell the full Stock Exchange unit; or, when short one hundred shares by odd lot sales, it may cover by buying in the full unit. Obviously the odd lot house carries a substantial risk of the market. However, it can deal with the alertness and swiftness of a floor trader, and with its large volume of business survives, and presumably profits, in spite of the risk and vast quantity of detailed work.

PRICE CONVENTIONS

Prices at which the odd lot dealer fills his orders depend directly on the current price of the one hundred share lots. If a buying order is "at market" the dealer fills it at a price one-eighth above the next one hundred share sale. The dealer, however, although in this case the seller, and responsible for the payment of transfer stamp taxes, adds the amount of these taxes to the price. Correspondingly, the dealer buys on a selling order at a price one-eighth below the next one hundred share sale. Here the seller is responsible for the payment of stamp taxes and pays them.

A broker's odd lot customer may give his order "at offer." In that case the odd lot dealer does not wait until the next one hundred share lot sale, but fills the order immediately at the bid and asked quotation. That is, if the current position of the stock is $86\frac{1}{2}$ bid, $86\frac{7}{8}$ asked, the dealer buys at $86\frac{1}{2}$ or sells at $86\frac{7}{8}$.

The order may be to buy or sell at the opening. Then, just as for any other transaction, the dealer makes a price based on the opening transaction. If in the rush of business at the opening there are simultaneous transactions at different prices, or it is not possible to determine what sale was first, then the odd lot dealers

in the stock agree on a "fair opening," which, unless there were special circumstances, would be halfway between the high and the low of the opening sales.

CLEARANCE OF ODD LOT TRANSACTIONS

Odd lots do not clear and reach settlement through the Stock Clearing Corporation. Indeed, the odd lot dealer must often delay delivery on his sales. His long stock in one hundred share unit certificates cannot be delivered directly. He must transfer into certificates representing the amounts of his sales, and the delay of the transfer office is likely to make delivery impossible at the time it would have to be made on a one hundred share contract of the same date.

CHAPTER LII

Long and Short Transactions

Speculation endeavors to gain advantage from a change in price. It does not matter whether the change is an advance or a decline. The Stock Exchange market has developed a mechanism for speculation for the fall. A man who buys stock in the expectation of benefiting by a rise in price is said to be "long," or a "bull." A man who speculates for the fall in price is said, from the method of carrying out the transaction, to be "short," or a "bear." We are not concerned here with the apologetics of the matter, but only with the techniques involved.

Amateurs in speculation tend to begin with the long transaction. The common idea of profit conceives it as arising out of buying at one price and selling at a higher price. It takes some maturity of thought to see that profit or loss arises out of the assumption of a risk, and that for a present owner the risk is that the price will fall, but for a prospective buyer the risk is that the price will rise. A man who assumes the hazard that a price will rise carries an economic risk of society just as much as a man who assumes the risk that a price will fall.

LONG TRANSACTIONS

The long transaction is simple. Let us assume that our speculator has a belief that XY common will advance in price, and that his belief is strong enough to induce him to act in the hope of profit from the advance. Assume then that he gives his broker an order to buy one hundred XY common, and that the broker executes the order at 85. We have already considered the course of executing the order. As a result of it the broker will be holding a certificate for these shares belonging to our speculator.

When the broker gets delivery of the certificate, however, he must pay for it — $8500. (In our costs we are omitting taxes and commissions.) We will assume that the customer is speculating

through a margin account and has a $4000 credit balance in his account available for the purchase. The broker must provide $4500.

BROKER'S SOURCE OF FINANCING

A broker who had to finance his customers out of his own capital would not be able to do a very extensive margin business. To carry his customers he must finance himself. He may do this by borrowing at the banks, or by "lending" his customers' certificates to a broker who must borrow to deliver on a customer's short sale. We will discuss both of these matters later.

REQUIRED AMOUNT OF MARGIN

The Federal Government has undertaken to regulate the amount of margin speculators must put up. A man may buy a refrigerator or an automobile on the smallest of down payments. He may own a house on the thinnest of equities, subject to a first, a second, and a builder's mortgage. But if he speculates in securities, he must do so on a basis of relative conservatism.

One must admit that the discrimination is not without reason. The Stock Exchange market suffers from its very efficiency. In most stocks a transaction can be effected in a few minutes. Published quotations give accurate market values every moment of the day. A price movement up or down tends to be cumulative until perchance it is checked by profit taking. If the movement is strong, the check may not be applied; or if profits are taken they are not in a sufficient volume of transactions to check the movement of the market.

If the market position of speculators, amateur and professional together, is predominantly long, as it usually is, and prices suffer substantial declines, some speculators will not be able to put up the additional margin required. The situation forces them to sell. Their sales add to the decline in price, and the further decline forces further sales. So thin margins accelerate price declines, and may carry them to an unduly depressed point, that is, below what we may call "fair value." Such a situation is a hardship on those investors who may need to liquidate. Moreover the relationship of the stock market to the banks which finance security transactions is so close that swift and disorderly liquidation of speculators creates a danger for the banks.

Economic dangers exist abundantly in the small down payment

instalment plan, and in the thin equity ownership of houses. The fact of a market so slow as to make it no market compared with the swiftness of transactions on the Stock Exchange obscures the dangers of credit in other fields. We do need a market on the Stock Exchange with a sufficient number of buyers and sellers to create a solid base of orderly trading. A thin market advances or declines too swiftly on a small amount of buying and selling. It may yet be found that a reduction in the margin requirements presented below is desirable.

Section 7 (a) of the Securities Exchange Act provides:

> For the purpose of preventing the excessive use of credit for the purchase or carrying of securities, the Federal Reserve Board shall, prior to the effective date of this section and from time to time thereafter, prescribe rules and regulations with respect to the amount of credit that may be initially extended and subsequently maintained on any security (other than an exempted security) registered on a national securities exchange. For the initial extension of credit, such rules and regulations shall be based upon the following standard: An amount not greater than whichever is the higher of —
>
> (1) 55 per centum of the current market price of the security, or
>
> (2) 100 per centum of the lowest market price of the security during the preceding thirty-six calendar months, but not more than 75 per centum of the current market price.
>
> Such rules and regulations may make appropriate provision with respect to the carrying of undermargined accounts for limited periods and under specified conditions; the withdrawal of funds or securities; the substitution of additional purchases of securities; the transfer of accounts from one lender to another; special or different margin requirements for delayed deliveries, short sales, arbitrage transactions, and securities to which paragraph (2) of this subsection does not apply; the bases and the methods to be used in calculating loans, and margins and market prices; and similar administrative adjustments and details. For the purposes of paragraph (2) of this subsection, until July 1, 1936, the lowest price at which a security has sold on or after July 1, 1933, shall be considered as the lowest price at which such security has sold during the preceding thirty-six calendar months.

Though the section goes on with much more extensive provisions, the part quoted is enough for our purpose.

Correlative with the specific provision for margins, the act also regulates loans by banks on securities, providing in Section 8 (a) that:

To borrow in the ordinary course of business as a broker or dealer on any security (other than an exempted security) registered on a national securities exchange except (1) from or through a member bank of the Federal Reserve System, (2) from any nonmember bank which shall have filed with the Federal Reserve Board an agreement, which is still in force and which is in the form prescribed by the Board, undertaking to comply with all provisions of this Act, the Federal Reserve Act, as amended, and the Banking Act of 1933, which are applicable to member banks and which relate to the use of credit to finance transactions in securities, and with such rules and regulations as may be prescribed pursuant to such provisions of law or for the purpose of preventing evasions thereof, or (3) in accordance with such rules and regulations as the Federal Reserve Board may prescribe to permit loans between such members and/or brokers and/or dealers, or to permit loans to meet emergency needs. Any such agreement filed with the Federal Reserve Board shall be subject to termination at any time by order of the Board, after appropriate notice and opportunity for hearing, because of any failure by such bank to comply with the provisions thereof or with such provisions of law or rules or regulations; and, for any willful violation of such agreement, such bank shall be subject to the penalties provided for violations of rules and regulations prescribed under this title. The provisions of sections 21 (Par. 211–216) and 25 (Par. 223–224) of this title shall apply in the case of any such proceeding or order of the Federal Reserve Board in the same manner as such provisions apply in the case of proceedings and orders of the Commission.

Presumably a requirement of substantial margins tends to reduce the volume of transactions. A speculator who must provide fifty per cent purchase price out of his own funds can carry only one hundred shares as compared with the five hundred shares he could carry if he had to put up only ten per cent of the cost. A speculator's purchase and sale of one hundred shares helps create a market just as much as a corresponding transaction by an investor. This fact has been one of the classic defenses of speculation on the stock market. In so far as the speculative transactions are needed to make up such an activity as keeps price changes within an eighth of a point, and enables contracts to be made at any instant, they do have an economic value in creating a market.

Probably the amount of speculation from time to time, and especially in some issues, is more than is necessary for market creation. Further, speculation tends to the more active issues. Perhaps a more nearly accurate statement is that the conditions for speculation are better in some issues than in others, and speculation tends to those issues in which conditions invite it. In

any case the result is that very likely more speculation takes place in some issues than is useful for market creation purposes, and not as much in other issues as would be helpful. The course of the market in October, 1937, demonstrated that high margin requirements are not effective in preventing a disorderly market on the decline. The mechanism of the Stock Exchange is delicately adjusted, and experimentation with it ought to be carefully and slowly done.

SHORT SALES

Long transactions are simple. The technique of the short sale is more complex. However, it is not difficult to follow.

For purposes of stock transactions one must distinguish between short sales and sales for future delivery. Much has been written in justification of short selling, to the effect that our economic system necessarily involves the risk of future prices. Any contract for future delivery involves the hazard that price at the time of delivery may be higher than at the time of contract. Some contracts in the general economic field are for future delivery because the thing to be delivered is not yet in existence, and the man who is to bring it into existence does not want to undertake the hazard unless he has such assurance as a contract may afford that he will be able to dispose of the thing at all, or able to dispose of it at a price which he believes will not cause him a loss. Other contracts for future delivery of things are solely for the purpose of protection against price change. The seller wants the assurance that he will not receive a lower price; the buyer that he will not have to pay a higher price. Economic risks exist. They must be carried. Further than this suggestion we will not delay to consider a justification of short selling on the Stock Exchange, but get on with a consideration of the technique.

On the Stock Exchange, contracts for *future delivery* arise for the most part out of some physical fact which interferes with an immediate transfer of possession of the stock certificates or bond. The paper may be in Chicago, or San Francisco, or London. It may be in the owner's safe deposit box, but the owner is in Chicago when he decides to sell. The reader will have noted that the contracts provided under the rules of the Exchange for future deliveries are for comparatively short periods.

A short sale is something different in the form of the transaction. It calls for an *immediate delivery*, and the problem is that of pro-

viding the certificate to deliver. The man in Chicago owning stock, but having the certificate in his New York safe, could have sold short and, on his return to New York, have "covered" his short position by delivering his certificate. However, he knows he has the certificate to deliver and may consider it more convenient to instruct his broker to make a contract for future delivery.

We are here concerned with the problem of a man who definitely desires to speculate for the fall. A man who owns one hundred shares of stock and sells one hundred shares short has engaged in a short sale transaction, but he has not put himself in a position to profit by a decline in price. He has hedged his long position. It becomes immaterial to him whether the market goes up or down. If it goes down he makes on his short transaction, but loses exactly the same amount in the value of his long stock.

One of the numerous plans of speculation which have come to the writer's attention involved going short on the shares of one stock and at the same time going long on the same number of shares of another stock. This irons out price changes of the market as a whole, whether arising out of the general economic trend or the technical position of the market, and affords an opportunity to the speculator to base his operations on his opinion of the values of the enterprise. A difficulty lies in the cost of commissions and taxes.

Let us assume that a man who is speculating for the fall instructs his broker to sell, say, one hundred XY common at market. Since the customer has no shares of this stock in his brokerage account, and has not said that he would deliver to the broker a certificate in time for the broker to make a delivery on the contract, the broker knows that his customer is engaging in a short sale. The broker's office instructs the floor member to sell one hundred XY common at market, and the member makes a contract exactly as if it were for the purpose of disposing of long stock.

The buying broker does not even know that the man with whom he deals is selling short. If he did, he would not care. All he is concerned with is that he has made a contract regular way for delivery of the stock under the rules of the Exchange on the second full business day after the day of the contract. How the seller is to get the stock for delivery is his worry, with which the buying broker feels no concern.

And, under the technique of the transaction, making delivery on the sale for a customer who has no shares to deliver is distinctly

the problem of the selling broker. The customer feels no concern with it. As far as performance of the contract goes, the customer gives his order for a short sale as blithely as if he were telling the broker to sell long stock. Let us see how the broker solves his problem.

BORROWING STOCK FOR DELIVERY

In the phraseology of the Exchange, the broker whose customer sells short "borrows" stock for delivery. The word, however, does not completely present the situation. For one thing, our language uses the word "borrow" ambiguously. When a housewife borrows her neighbor's silver teaspoons, the neighbor expects a return of the identical spoons. We have what law language calls a bailment. If the housewife borrows a pound of sugar, the neighbor does not expect a return of the identical sugar, but of a like amount of like sugar. Obviously, a certificate of stock for delivery on a short sale is borrowed in the sense of the housewife borrowing sugar.

TERMS ON WHICH CERTIFICATE IS LOANED

Our description of the borrowing transaction might perhaps even more appropriately speak of it as a loan of money than as a loan of stock. For when the broker who loans the certificate delivers it, he receives from the borrowing broker a sum of money equal to the full market value of the shares. Each of the two brokers receives a *quid pro quo* for the value he parts with. If immediately thereafter the broker who has loaned the certificate should call for its return, and the broker who has borrowed should fail to return it, the lending broker could liquidate the breach of contract by using the funds he received from the borrowing broker to buy the shares in the market. In a sense each broker has security for performance by the other.

What if the price of the stock advances or declines in the market? If it advances, the broker who has loaned the certificate is no longer on a parity of values with the broker who has borrowed it. If the stock was 85 at the time of the borrowing, and advances to 95, the broker who has borrowed the certificate has an obligation to return a certificate worth now $4750, but the broker who loaned the certificate received only $4250 at the time of the transaction. If the broker borrowing the certificate should become in-

solvent, the broker lending might have a loss up to $500. He would be an unsecured creditor for that amount. Therefore, in order to keep the two brokers on a parity of values, the broker who has borrowed the certificate puts the broker who has loaned it in funds from time to time as the market advances. Conversely, if the market falls, the broker who has loaned the certificate pays back enough of the funds he has received to maintain the parity of values. This process of maintaining parity is called keeping the loan "at market."

TRANSACTION VIEWED AS A LOAN OF MONEY

As we have remarked, we might consider the transaction as a loan of money, with the certificate received essentially as collateral. Of course the relationship of pledgor and pledgee is not created. The broker receiving the certificate is not bound at all times to have on hand stock to deliver back on repayment of the funds. Such a requirement would entirely defeat the purpose of the transaction. The very reason the broker for a customer going short has borrowed a certificate is that he may have one to deliver to the broker who has bought on the short sale. Ownership of the stock changes.

The broker who had the certificate to loan had it to carry for a long customer on margin. The broker finances the customer, and correspondingly must finance himself. He could do this by adding the stock to his collateral at the bank for an increased loan. The Securities Exchange Act, Section 8 (a), governing loans to brokers, has already been quoted. Regulations of the Commission provide that the regulations of the Federal Reserve Board for the initial extension of credit shall be upon the following standard:

> An amount not greater than whichever is the higher of —
> (1) 55 per centum of the current price of the security, or
> (2) 100 per centum of the lowest market price of the security during the preceding thirty-six calendar months, but not more than 75 per centum of the current market price.

This is the same as the provision of the act for customers' margins. So the broker would be able to borrow as much as he loans to his customer. Under former conditions the broker might well be lending his customers more than he could borrow at the bank. His capital was part of his means of competing for business.

We see the short sale, however, providing the broker with a way of essentially borrowing more than he lends to his customer. He may lend his customer at the very outside not more than seventy-five per cent of the market value of the stock. But if he utilizes the stock by lending it to a broker borrowing a certificate to deliver on a short sale, he receives funds of one hundred per cent of the market value of the certificate. Under present margin limitations and credit conditions enabling the broker to borrow bank funds up to the full amount he can loan the customer, the advantage of what we may call the surplus financing provided by the loan of the certificate for delivery on a short sale may not be so great as formerly, when the broker loaned his customers more than he could borrow at the banks on the customer's collateral.

SOURCE OF FUNDS WHICH BROKER WHO BORROWS CERTIFICATE ADVANCES TO BROKER WHO LOANS CERTIFICATE

Where does a broker who advances money on receipt of a borrowed certificate procure the funds? The broker for a long customer has the customer's stock to use as collateral; by very definition the short customer has no stock to be used as collateral. But the broker on the short sale will be delivering the borrowed stock in performance on the short sale contract. When he makes the delivery, the purchasing broker will have to make payment. The contract for borrowing the certificate was made on the same day that the contract for delivery was made on the short sale. The borrowed certificate will be delivered on the same day that delivery is made on the short sale contract. The funds which the certificate borrowing broker advances to the certificate lending broker will be reimbursed through the funds received by the certificate borrowing broker on his delivery of the borrowed stock. We have an essentially self-financing transaction.

ADVANTAGE OF THE TRANSACTION TO THE BROKER FOR THE SHORT CUSTOMER

It is seen that the broker for a short customer has to perform the extra labor of procuring stock for delivery. More than offsetting this, however, he does not have to finance his customer. The customer's transaction is, as we have seen, self-financing. Further,

he will have some of his customer's funds. For the customer must margin a short as well as a long transaction. If the stock sold short at 85 should rise to 95, the broker would have a loss of $1000 on a one hundred share transaction unless protected by the customer. Assume that the margin is thirty per cent. Then the broker has $2550 of his customer's funds.

PROBLEM OF DIVIDENDS

Dividend payments complicate the short transaction. In the complete transaction we have these participants:

(1) Customer selling short and the short sale broker.
(2) Customer owning loaned stock and the stock lending broker.
(3) Customer buying on the short sale and his broker.

We will assume that all three accounts are on margins.

Since the stock pays dividends, the broker buying on the short sale will have the shares transferred into his name. He holds the stock as collateral for his customer's indebtedness, and, therefore, keeps it in form so that he can make a sale on his customer's default. So the stockholder of record is the broker, and the corporation pays the dividend to him. He, of course, credits the amount of the dividend to the customer's account.

But the customer owning the loaned stock has a right to the dividend. He is long of the stock. To be sure, in the general waiver he signed on opening his account, he has consented to this use of his stock by the broker. Such a consent has deprived him only of his right to have the broker hold at all times shares ready for delivery to him. The customer has not parted with his right to any dividends that the corporation may declare while he owns shares. If the broker utilized the stock by pledging it for a loan, the dividends would be paid to him and he would credit them to the customer's account. Since he has elected the alternative use of lending the stock, he will still have to credit his customer with the amount of the dividend which he will not receive from the corporation.

Such a credit to the customer who owned the loaned stock is not a price paid by the broker for the privilege of utilizing the shares in this way, but an expense of the short transaction to the man who engages in it. The broker who has loaned his customer's stock charges the amount of the dividend to the broker who has bor-

rowed the certificate, and he in turn charges it to his customer's account. Still, though we have just called the dividend an expense of the short transaction, it is not really so. Let us see how the matter works out.

What happens in the market for the stock on the event of the corporate dividend? We have the three corporate steps of: (1) declaration of the dividend; (2) the date on which, in accordance with the resolution declaring the dividend, the list of shareholders to receive it is taken; (3) the date on which the dividend is to be paid. On any transfers made after the date for making up the list of stockholders of record to receive the dividend, the dividend will not be paid to the new stockholder, but to the one who was the record owner when the list was made up.

Delivery of shares sold regular way on the Exchange, we have seen, does not take place until the second full business day after the contract on the floor. And, of course, the buyer cannot present the stock for transfer into his own name until he has a certificate to present for transfer. So a stock sells "ex-dividend" on the first day on which certificates delivered on contracts made that day cannot be transferred before the drawing off of the list of stockholders who are to receive payment of the dividend.

Since buyers on the ex-dividend day will not receive the dividend, and sellers on that day will, the stock is worth to the buyer at the opening that morning just the amount of the dividend less than it would have been worth if he had bought at the close of the day before. So if the dividend is two per cent, and the stock closed at 87 the day before it goes ex-dividend on the Exchange, it should open at 85 on the ex-dividend day. If it opens higher than 85, it has really opened above the close of the day before. That is, if it should open at $85\frac{1}{2}$, the situation, disregarding the dividend, is really as if it had opened at $87\frac{1}{2}$.

A man who had sold short at 87 the day before the stock went ex-dividend on the Exchange could cover the next morning at 85. He can apparently make a two point profit (disregarding commissions and taxes) on his transactions. Actually this price change does not in the least enable him to make a profit. His broker will debit his account the two points. This makes up the amount the broker on the short sale must credit the broker from whom the stock for delivery on the short sale was borrowed. We have seen that the broker lending the certificate must credit his customer with the amount.

Let us now assume a completed short transaction and compute the profit or loss:

A on July 10 sells one hundred common short at 85. He continues his short position until September 15, when he covers by buying one hundred XY common at 90. In the meantime the stock went ex-dividend two points on August 28.

Bought 100 at 90	$9000
Sold 100 at 85	8500
	500
Dividend	200
	700
Selling commission	20
Federal and State stamp taxes, Federal 5¢ a share, New York State 2¢	7
Buying commission	20
	$747

So the speculator is out $747 on his short transaction besides having tied up for the period the amount of margin involved.

KEEPING THE CUSTOMER SHORT

When a customer sells short he may want to cover at any time. Likewise the customer of the broker who has loaned the certificate may want to liquidate his long position at any time. So the lending transaction is on demand both ways. The broker lending the certificate can call for redelivery of the stock on which he will repay the funds advanced. The broker advancing the funds can redeliver the stock and require payment of the cash advances. If the stock lending broker requires the stock back, the broker for the customer continuing a short position will have to borrow the stock from some other broker willing to lend it.

FURTHER TERMS OF THE LOAN OF THE CERTIFICATE

As we have seen, the broker for a customer long on margin account can finance the transaction either through bank loans with the customer's stock as collateral, or by lending the stock for delivery on a short sale. If he borrows bank funds, he will have to pay current interest rates on Stock Exchange collateral loans. He will recoup himself by charging his customer interest. Indeed, the broker may make a profit on his interest account. When bank

Stock Exchange collateral loans are at, say, four per cent, the broker may charge the customer six. A customer doing a large volume of business may exact better terms; may, indeed, get the full benefit, or nearly so, of the bank rates. If current bank rates rise above six per cent, the broker will charge his customers at least the full bank rates.

A reader knowing perhaps the strict usury laws of the State of New York making interest in excess of six per cent usury, and allowing usury as a defense even to payment of the principal sum due, may wonder how banks or brokers can successfully charge more than six per cent. There are several exceptions to the usury law. A corporation promising to pay more than six per cent may not take advantage of usury as a defense. For the small loan business the Banking Law provides (Section 352) that licensed lenders, for loans not exceeding $300, may charge three per cent a month on unpaid balances. And Section 379 of the General Business Law provides that:

> In any case hereafter in which advances of money, repayable on demand, to an amount not less than five thousand dollars, are made upon warehouse receipts, bills of lading, certificates of stock, certificates of deposit, bills of exchange, bonds or other negotiable instruments pledged as collateral security of such repayment, it shall be lawful to receive or to contract to receive and collect, as compensation for making such advances, any sum to be agreed upon in writing, by the parties to such transaction.

One rather surmises that brokers sometimes charge more than six per cent in small margin accounts in which the loan is less than $5000. Also, one further surmises that some brokers might find it difficult to produce a written agreement under which they make a greater charge than six per cent.

A broker lending a certificate for delivery on a short sale gets the use of funds in an amount equal to the full market value of the stock, and these funds are worth to him the current rate of interest. If the amount of short transactions in that stock is moderate, he will ordinarily pay the current interest rate to the broker advancing the funds.

LOANING FLAT AND PREMIUM FOR USE

It may be, however, that the short interest, or volume of short sales, in a given issue becomes so great that brokers selling for cus-

tomers on short transactions find difficulty in borrowing certificates to deliver. It is a familiar fact of the market that some issues are much more closely held than others. That is, the number of shares held in speculative accounts is relatively small. So the floating supply of long stock held in margin accounts and available for loaning may be much in demand by borrowers as the short interest in the issue increases. Then those who have stock available for loaning may be able to drive a better bargain than usual and get the use of the funds advanced on the loan of the shares without the payment of any interest. In that event the stock is said to loan "flat."

Sometimes the supply of stock available for loaning becomes so small in relation to the demand that the broker who has stock to lend, besides procuring the use of the funds advanced without paying any interest, can even command a payment in addition. In that case the stock is said to loan at a "premium."

CORNERS

What if the situation becomes extreme, and those who have sold short find it impossible to borrow stock to deliver. Then we have what is called a "corner" in the market. Strictly an absolute corner does not exist unless the number of shares sold short exceeds the number of shares in the entire issue. Then it would be mathematically impossible to procure sufficient stock to deliver on all the short sales. A squeeze, or effective corner, exists whenever the short seller cannot in fact procure stock to deliver.

Some corners have developed out of the course of events without conscious endeavor on the part of anyone. Manipulative speculators have brought others about. A speculator carrying a large long interest, and continuing to buy on the short sales of others, may find himself loaning his own stock for deliveries to himself. In due course, believing that he is in control of so much of the floating supply of the issue that the shorts cannot borrow sufficiently elsewhere, he may refuse to lend more stock and call in all the stock he has loaned. When the shorts find that they cannot procure stock to return that which they have borrowed, they must make a settlement with the manipulator. In the meantime the endeavor of the shorts to buy stock and cover has sent the price far beyond what a free market would find to be a fair value. The measure of damages for failure to return borrowed stock is the

price at which the lender of the stock can buy it in at the market less the funds he received from the borrower at the time of the loan transaction or afterwards. In practice the manipulator and the shorts arrive at a settlement.

It is the function of the Stock Exchange to provide a free market in which price is a resolution of the forces of the opinions of buyers and sellers as to value. Anything which interferes with a free market interferes with the function of the Exchange. A corner prevents a free market and, especially if resulting from manipulative endeavor, tends to bring the Exchange into disrepute.

So the Exchange has adopted a method effective in practice to break virtual corners arising out of control of the floating supply of stock. In the endeavor to create the corner or squeeze, the man in control of this supply calls for the return of loaned stock. Under the rules of the Exchange the borrowers must deliver, as if in performance of a contract to sell, on the second day. But the borrowers can find no stock to return at that time.

However, the Governors of the Exchange can suspend the rule for delivery, and allow one week, or two weeks, or three weeks within which to deliver. A market situation which has sent the price of the stock up far beyond anything that would have to be bid for it in a free market will bring into the market shares held for investment. The shorts may have absorbed all the shares in and immediately around New York City, but there are still shares in Cleveland, Chicago, Cincinnati, St. Louis, and San Francisco. There are shares in London, in Amsterdam, and elsewhere in Europe. With prices far beyond any normal valuation, the owners of these shares would be glad to liquidate. Given the opportunity, they will grasp it.

If the rule for delivery is suspended, and the shorts have the chance to buy distant stock and have it ready for delivery within the time available under the suspension of the rule, they will be able to break almost any corner likely to be achieved.

CHAPTER LIII

Clearance and Deliveries: Work of the Stock Clearing Corporation

Development of the process of performance of contracts made on the floor of the Exchange has been continuous since the beginning of trading there. The endeavor has been to reduce the labor and the volume of transference of funds; the result involves paper work which seems intricate to the casual observer, and puzzles him. It is all rather elaborate detail of a fairly simple whole.

The earlier and simpler processes continue in use for some transactions. Since the present system developed from those processes, it may be easier to come to an understanding of what is done now by considering first the simpler form.

WHAT A SETTLEMENT WOULD BE WITHOUT THE CLEARING HOUSE AS INTERMEDIARY

Let us review the problem. As we have seen in the chapter on executing orders, the steps involved are (1) making the oral contract on the floor of the Exchange; (2) reducing the contract to the form of written memoranda, one for the buyer signed by the seller, one for the seller signed by the buyer; (3) performance of the contract by delivery of the stock and payment.

We have seen that the telephone clerks of the buying and selling brokers notify their respective offices of the terms of the contract just made. And we have seen that the office of the seller prepares tickets setting forth the terms of the contract and signs one and delivers it to the buyer with a corresponding ticket for the buyer to sign. Also we have seen that the buyer compares these tickets with the firm's own record of the transaction as reported by its floor member. If there is a discrepancy the matter must be ironed out. If the respective floor members do not disagree about what took place, the error arises out of some mistake in

transmission or entry and can be cleared up. On a disagreement of the floor members the firms come to an adjustment voluntarily, or if they cannot do this, by compulsory arbitration under rules of the Exchange. Disregarding the development of the Stock Clearing Corporation, with its Distributing Department, the brokerage firms would exchange this ticket for comparisons directly between their offices.

Assuming that the two offices are in agreement, they still have to carry through performance of the contract by delivery and payment. Still disregarding the Stock Clearing Corporation, with its development of a central delivery department, the course of business would be the tender of the certificate by the seller at the office of the buyer; and the buyer, inspecting it, and finding it a "good delivery," would make payment. The receiving clerk of the buyer would examine the certificate for its genuineness and to see that it is properly endorsed for transfer, with the signature of the endorsing stockholder satisfactorily guaranteed. On finding these requirements met, the buyer would deliver a check in payment. This check would be uncertified on its delivery, but the seller would promptly take it to the bank on which it was drawn and get it certified. As we shall see, the money settlements are made through the Stock Clearing Corporation, as well as the exchange of comparison tickets and the delivery of the certificate. We have noted the things that must be done in some completely nonclearing transaction and will endeavor to show the ways in which the Stock Clearing Corporation reduces the amount of work involved in attaining the result for a clearing transaction. It is a study in the development of business mechanisms, and shows an evolution like that of mechanical inventions.

STOCK CLEARING CORPORATION

The Stock Clearing Corporation has two divisions, the Night Branch and the Day Branch, and was organized in 1920. The Night Branch took over the work formerly done by the Clearing House of the New York Stock Exchange organized in 1892. Before that year the processes of comparison, delivery, and payment were carried on directly between office and office in the manner indicated at the beginning of this chapter. Without further remarking at this point on the Stock Clearing Corporation as a whole, we will immediately consider the work of the Night Branch.

STOCK EXCHANGE CLEARING HOUSE — NIGHT BRANCH OF STOCK CLEARING CORPORATION

Probably the reader is familiar with at least the function of a bank clearing house, and perhaps with its method of operation. This central institution for determining the aggregate of the obligations of one member bank to all other member banks, and correlatively the rights of the one bank against all the others, saves a vast amount of labor. If the one bank owes all the others more than the total of their obligations to it, the bank through the clearing house can settle with a single check. Correlatively, if the total of its credits exceeds the total of its debits, it can collect by a single draft.

Clearance for banks presents a simpler problem than clearance for Stock Exchange firms. Banks have only one thing to settle, cash; but Stock Exchange firms owe each other not only cash, but also stock. And the stock has been bought and sold through the whole range of prices for the day. We have, however, the two balances: the balance of cash and the balance of securities. It is one of the logical truths that in the debtor-creditor relationship the amount the debtor is under a duty to pay just equals the amount the creditor has a right to receive; and in the buyer-seller relationship, that which the buyer has a right to receive is the same thing that the seller is under a duty to deliver.

So the result of a day's transactions on the Stock Exchange is that for any issue the aggregate of the number of shares to be delivered equals the number of shares of that issue to be received; and the aggregate of the payments to be made equals the aggregate of the payments to be received. One difficulty obstructs the course of arriving at a process of clearance: the relationship between the cash and the shares. Each amount of cash is to be paid on the receipt of a specific item of shares bought and sold; and the prices on the transactions in a given issue have varied through the day.

If on a certain day Broker A sold one thousand shares of XY common and bought nine hundred shares, and on the same day Broker B bought seven hundred shares and sold six hundred shares of the same stock, the transactions of A and B in that stock could be "cleared," if it were not for the price difficulty, by having A deliver one hundred shares to B. But if the various transactions have been at different prices, as would be the case, and if B is to

pay A for the one hundred shares delivered, at what price shall the payment be made?

In effect the Clearing House solves the difficulty by conceiving all the duties to pay cash and to deliver stock as due to it, and all the rights to receive cash and stock as rights against it. These correlative rights and duties will be settled if the Clearing House sees that the affairs of each broker on a day's transactions are settled by his having as much more or less stock of each issue as he ought to have, and as much more or less cash in the aggregate as he ought to have. If, continuing our illustration of the preceding paragraph, B, as a result of the day's transactions, has one hundred shares of XY common more than he had at the beginning of the day, he is in the position he ought to be in. Correspondingly, if the aggregate of payments to be made by B on the day's transaction is $200,000 and the aggregate sums to be received by him is $190,000, and B pays the balance of $10,000 in cash, he is in the cash position he ought to be in.

Let us now see how the Night Branch of the Stock Clearing Corporation settles the transactions of all the brokers so that each is in the position he ought to be in with respect to both stock and cash.

CLEARANCE SHEETS

Remember that we are to find the solution of the problem in considering all the obligations of all the brokers as if due to the Clearing House, and all the rights of all the brokers as if against the Clearing House. In working out the problem in practice, the scope of this generality is much reduced. The less active issues of stock are not admitted to clearance, and of bonds only the most active issues are cleared. This leaves the process of settlement to be dealt with outside of the work of the Night Branch. Moreover two brokers may be in disagreement over a transaction. If, on the receipt of the comparison tickets prepared by the seller, the buyer does not agree with their statement of the transaction, the contract must be performed without the assistance of the Night Branch.

So we find the Clearing House settlement somewhat reduced by its limitation to (1) transactions about which there is no disagreement in (2) clearance issues. The fact that brokers are in accord as to the terms of the transactions is important. The Clearing House does not enter into disputes between brokers. It deals only with liabilities they fully admit.

Each Stock Exchange firm delivers to the Night Branch a "clearance sheet" which sets forth all the unquestioned transactions in cleared issues made by it during the day. With the clearance sheet the firm transmits its deliver and receive exchange tickets for the day on all the transactions entered on the sheet. So the Night Branch has the signed memoranda of every entered transaction, and they prove to the Clearing House that the parties are in agreement.

Let us consider a hypothetical clearance sheet, that of Jones and Company. It presents the following transactions:

Receive Side of Clearance Sheet of Jones and Company

Receive from	*No. of Shares*	*Security*	*Price*	*Value*
Brown and Company	100	U. S. Steel	$67\frac{1}{2}$	$6,750
Smith and Company	100	DuPont	$158\frac{1}{4}$	15,825
Robinson and Company	100	Motors	$66\frac{1}{4}$	6,625
Tanner and Company	100	Gen. Elec.	$46\frac{1}{2}$	4,650
				$33,850
Balance to deliver	100	Motors	66	6,600
	100	N. Y. Cent.	39	3,900
				$44,350

Deliver Side of Clearance Sheet of Jones and Company

Deliver to	*No. of Shares*	*Security*	*Price*	*Value*
Cook and Company	100	U. S. Steel	67	$6,700
Briggs and Company	100	DuPont	$157\frac{1}{2}$	15,750
Mason and Company	200	Motors	$66\frac{1}{2}$	13,300
Bright and Company	100	Gen. Elec.	46	4,600
Brown and Company	100	N. Y. Cent.	$39\frac{1}{4}$	3,925
				$44,275
	Check			75
				$44,350

For ease in presentation a brief and simple set of transactions has been taken. Obviously, for a commission firm to continue to live, it must average to do a much larger day's work than this. But it will serve our purposes. It presents nine transactions with eight different firms, and includes five stocks. If there were no clearing, that would be four items of securities to receive; four checks aggregating $33,850 to issue in payment; five deliveries to make, with five checks aggregating $44,275 to collect, get cer-

tified, and deposit. If all this were done, the net result would be that Jones and Company would have one hundred shares of General Motors and one hundred shares of New York Central less than they had, and would have $75 less cash.

If the clearance sheet were just reversed, and all the purchases were sales, and all the sales were purchases, the entry of "balance to deliver" would become "balance to receive," and the entry of "check" to balance would become "draft" to balance.

On checking all the clearance sheets and the supporting exchange tickets, the Clearing House would find a sheet of some broker or brokers disclosing a right to receive one hundred Motors and one hundred New York Central more than they were obligated to deliver. Assume that Thompson and Company have a right to receive one hundred New York Central, and Smith and Company a right to receive one hundred Motors, more than they are obligated to deliver. The Night Branch then instructs Jones and Company, the firm whose clearance sheet has been presented, to deliver one hundred New York Central to Thompson and Company, and to deliver one hundred Motors to Smith and Company.

But at what price shall the delivery be made? Thompson and Company may have contracted for New York Central at 38, and Smith and Company have contracted for Motors at 67. The only difference the delivery price would make would be to change the cash balance. The price for the New York Central might be arbitrarily fixed at 25, and for the Motors at 75. In that case the credit for the delivery of the Central would be $2500; and for the delivery of the Motors $7500; an aggregate of $10,000. The changed entries on the clearance sheet would be:

Total value of stock to receive	$33,850
Balance to deliver:	
100 Motors at	7,500
100 N. Y. Central	2,500
	$43,850
Draft to balance	425
Total value of stock to deliver	$44,275

So the whole matter would wash out in the cash balances. The only advantage to be gained by any particular delivery price is a reduction in the amount of cash clearance. Actually the Exchange takes the whole figure nearest the closing as the delivery price. If the closing for Motors was $65\frac{7}{8}$ and for New York Central $39\frac{1}{4}$, the whole figure nearest the closing would be 66 and 39, and these

are the figures we have taken as representing the clearance delivery price.

Let us assume that when Jones and Company deliver these two items they collect from Thompson and Company the $3900 for the New York Central, and from Smith and Company $6600 for the Motors. This is what Jones and Company would have done before the development of money settlements in the Day Branch of the Stock Clearing Corporation. For the purpose of clearance it makes no difference how the cash settlement is actually made. The Clearing House, in its settlement with Jones and Company, credits itself with the $10,500 the delivering firm will receive outside the Night Branch settlement. This credit leaves the firm indebted to the Clearing House in the sum of $75, and the firm settles by sending with the clearance sheet a check to the order of the Stock Clearing Corporation for that amount. If the cash balance of Jones and Company on the clearance had fallen the other way, so that instead of paying out cash the firm should receive cash, the firm would have drawn a draft on the depositing bank of the Night Branch, the Bank of Manhattan Company, and attached the draft to the clearance sheet. The manager of the Night Branch signs the form of approval on the draft, which goes back to Jones and Company, who deposit it to the credit of their own bank account.

STOCK LOANED FOR DELIVERIES ON SHORT SALES CLEARED THROUGH THE NIGHT BRANCH

We are now able to pick up another of the threads entering into the aggregate of settlements between Stock Exchange firms. We have considered the process of the short sale, and seen that it involves the borrowing of stock for delivery, and advancing against the borrowed shares money equal to the market value of the stock. The transaction has the aspects of a sale of the stock; i.e., delivery, and payment of the price. There is the additional aspect of, in substantial effect, an agreement to repurchase the stock on demand of the short sale broker, and, on his part, to resell the stock at market to the broker who has supplied it for delivery on the short sale. For the purposes of performance the transaction is treated as if there were an actual sale of the stock on these terms; so it is entered on the clearance sheets of the respective brokers.

WORK OF THE DAY BRANCH OF THE STOCK CLEARING CORPORATION

We have seen that the work of the Night Branch of the Stock Clearing Corporation greatly reduces the work of delivery and payment, but does not entirely abolish it. We see that for issues admitted to clearance there are still balances of securities to deliver. And the Exchange firms still have the problem of delivery of securities of issues not admitted to clearance and of cash settlements on such deliveries. The Day Branch has taken over most of this work, and also the large task of the settlement of broker's collateral loans.

PROBLEM OF DELIVERY AND PAYMENT WHEN THE USE OF CREDIT IS INVOLVED IN THE TRANSACTION

One problem recurs throughout the field of business: that of bridging the financial gap between making payment for something purchased for resale and receiving payment on the resale. The gap is a fairly long one in the matter of financing an inventory of a manufacturing enterprise, or even of a merchandising concern. To help bridge that gap, business has developed the various devices of ordinary current credit. In many transactions, however, the time of the financing is very much shorter. Only the period of a clearance has to be bridged. When a syndicate participant sells a block of bonds to a client, the participant "takes down" the bonds, that is, transmits funds to the syndicate manager to free the bonds from the syndicate account for delivery to the purchaser and collection of payment. The participant provides the funds for the clearance.

Simultaneous delivery and payment present the ideal of any transaction of sale. Both buyer and seller then have the thing they have bargained for. The seller does not run the risk of parting with the thing sold and not getting paid. Or, a much less frequent situation, the buyer does not risk paying the price and not getting the thing bought. Far more than in most markets men in the Stock Exchange business maintain simultaneous deliveries and payments. Our economic system might function better if the contrary practice were less used in other fields.

One way of avoiding the full hazard of credit would be to create an "escrow" for the purpose of a clearance. Assume that A knows

he can buy from S and sell to P. But both S and P require the protection of simultaneous delivery and payment. However, A does not have the cash to pay S and cannot collect from P without delivering the goods. At the request of A, however, S is willing to entrust the goods to X, who undertakes with S not to part with the goods until he receives payment, and then to pay S. In this case the bailee X is in the same position as a trustee bound to deal with the particular things of value for the particular purposes. If he does not get the cash from P, he must return the goods to S. We will see the Stock Clearing Corporation assuming the essential outside party position of X and coming to the assistance of the broker for his clearances. We shall see that it does much more than X in the simple situation just described. Let us consider the various special services it renders the broker.

CENTRAL DELIVERY

It undertakes to deliver securities and collect payment therefor, and to receive securities and pay for them, on behalf of member brokers. This includes, as we shall see, the clearance of collateral loans. But we are not ready yet to go into that matter. If it were only delivering securities and collecting payments its affairs would be simple; they become more complex on its undertaking to receive and pay for securities. Of course if the broker put it in funds to make the payment, that would be simple. In effect it arranges the single day clearance financing of the broker.

CLEARANCE FUND

The Night Branch, which we have sometimes called by its name of the Stock Exchange Clearing House which it bore before the Stock Clearing Corporation took over its function, does not require capital. Each day it receives checks aggregating in amount the drafts drawn on it. If a check is over $5000 in amount, it has the check certified. But to handle the day financing of its broker members it needs funds. So it has an actual capital stock of $500,000 owned by the New York Stock Exchange, and a clearing fund contributed by Stock Exchange firms which are clearing members of the corporation. The minimum contribution required for the clearing fund is $10,000, and the amount increases with the volume of the member's clearance business. Further, the member

may be assessed up to an amount equal to the amount of his contribution.

We should note that securities delivered and received through the Day Branch are not limited to issues admitted to clearance in the Night Branch, but include all stocks and, in addition, those bonds which are admitted to clearance in the Night Branch.

DELIVERY OF SECURITIES THROUGH DAY BRANCH

Our brokerage office makes ready the securities it must deliver that day, and groups the items it has to deliver to each receiving firm. Those which go to each firm constitute a single delivery. The delivering firm prepares a tripartite ticket listing the securities for each delivery. These tickets name the firm to which the delivery is being made and list the items and their delivery prices. They include the security balances deliverable under the direction of the Night Clearing Branch and stocks not cleared in that branch. Also the delivering firm prepares in triplicate a "credit list" setting forth all the deliveries, the prices, and the total value of all the deliveries.

A messenger of the delivering house takes these various deliveries to the quarters of the Day Clearing Branch. Each member firm is assigned to one of the receiving windows and to one of the delivery windows. Our messenger goes to the receiving window for the firm and hands in the deliveries with their tickets attached and the triplicate credit list.

There the clerk in charge receives the papers, checks the lists, and checks the securities to the extent of seeing that in amount they agree with the lists. He then stamps one of the three parts of the credit list, "The above securities have been received and verified as to count, but not as to validity, transferability, or deliverability," and hands it back to the messenger. It is his receipt for the deliveries.

From the receiving clerk's window the securities and attached tickets go to the sorting tables. Here all the deliveries to each member are brought together with their attached charge tickets, and the lot is sent to the delivery window to which that member is assigned. So the messenger from our office will presently find awaiting him at the firm's delivery window all the securities to be delivered to it. He takes the items, signs one of the parts of the ticket attached to each delivery, leaves it as a receipt to the Stock

Clearing Corporation, together with an unsigned part, and takes the third part with the securities.

Within the quarters of the Day Branch, each member, as well as being assigned to a receiving window and a delivery window, is assigned to one of the eleven cages where his accounts with the Day Branch are kept. We have seen that the Stock Clearing Corporation has retained two parts of the delivering firm's credit list and two parts of the delivery tickets. One of the parts of the credit list goes to the delivering firm's account cage, and there the value of the delivery is debited to its account.

BANK DELIVERIES

New York banks may take advantage of the delivery facilities of the Stock Clearing Corporation for the delivery of securities to each other, and Stock Exchange firms can make deliveries to banks through the corporation.

CLEARANCE OF COLLATERAL LOANS

As another great task the Day Branch clears the loans banks make to Stock Exchange firms on collateral security. In this service we find the Clearing Corporation essentially fulfilling the function of a holder in escrow. But before we go on to a description of this work we need to consider the loans themselves.

COLLATERAL LOANS

Brokerage firms borrow from banks both on time and on demand. In either case they give the bank collateral security. We have already considered the matter of brokers mingling the securities of customers and pledging them for a single loan. And we have further seen the requirements of the Securities Exchange Act with respect to customers' margins and the amount that banks may loan on stock and bond collateral.

We will not concern ourselves here with the bank's requirements with respect to the character of the collateral further than a broad general statement of principles. In the event of failure of the borrower to pay, the bank needs to be able to sell the collateral readily for an amount sufficient to cover the loan. Marketability and relative stability of price are the desiderata. Even though an issue is listed on the Stock Exchange, it may not enjoy

CALL MONEY RATE AND RENEWAL RATE

The clerk cannot negotiate the loan. Offerers of money and applicants must agree on terms of rate and collateral. A bank may offer its money at a fixed rate, and a broker may find the rate acceptable. Or the bank may leave the rate open for agreement. When a bank and broker have come to terms the rate is posted at the loan desk. So there is in effect a series of quotations on loans, with an interest rate based on demand and supply.

Such a loan is essentially a loan from day to day, and is deemed renewed unless called or voluntarily paid off. For the purpose of determining interest, however, the Executive Committee of the Stock Clearing Corporation arrives at a renewal rate which is posted at the money desk and transmitted over the ticker. In fixing the rate, the Committee takes into account the existing money conditions and opinions of lenders and borrowers. Meeker says: "Statistics show that during the years 1922–29, the average variation between the average of renewal rates and that of new loans made, has amounted to only 0.04 of 1%, and in some years has been as low as 0.005 of 1%. These figures are conclusive proof of the accuracy with which the renewal rate habitually accords with current rates for new loans, which are of course established purely by bartering between lenders and borrowers." [1]

PROBLEM OF SHIFTING LOANS

When a bank calls a loan, or when a broker wishes to arrange a new loan in order to pay one outstanding, the broker has the old problem of simultaneous delivery and payment. The new lender wants the agreed collateral, and the present lender does not want to release its collateral until its loan is paid. Also the broker is taking delivery of securities bought for his customers, and must finance the payment; but he cannot utilize the securities as collateral until he obtains possession of them by payment.

DAY LOANS

To meet this situation pending the coming in of collateral, the practice of "day loans" developed. A day loan is simply one un-

[1] J. Edward Meeker, *The Work of the Stock Exchange*, Revised Edition, p. 296.

secured for a few hours to provide the funds with which to make payment for securities received on deliveries or to pay off a collateral loan. It presents an undesirable situation arising out of the exigencies of business. The Stock Clearing Corporation has provided the means for greatly reducing the amount of such loans to its members.

CLEARANCE OF COLLATERAL LOANS

Banks lending money on call become "lending members" of the Stock Clearing Corporation, and the Day Branch provides for them booths where they can handle their transactions. Without going into all the details, we can perhaps see the essentials of the process.

A bank telephones a broker that it calls his loan; or, conversely, the broker telephones a bank that he will pay its loan. Then the broker prepares and signs, in three copies, an agreement presenting an itemized statement of the collateral and its market value, and takes it to the bank. On its being found correct, the bank retains one copy and signs two, which the broker takes to the Day Branch.

Then a representative of the bank having its loan repaid brings the collateral to its booth at the Day Branch, where the Clearing Corporation's clerk checks it with the list of it handed in by the broker. On finding the items correct he delivers to the bank representative a draft of the Corporation on one of the banks in which it keeps clearing funds. Now the Clearing Corporation has possession of the collateral.

Correspondingly the broker in arranging his new loan makes out and signs a quadruplicate agreement presenting a memorandum of the collateral to be furnished, and takes it to the bank making the loan. If the bank finds the proposed collateral satisfactory, its officer signs two copies of the memorandum, hands them to the broker, and retains the other two. The broker takes his two signed copies to his account cage at the Day Branch. A representative of the lending bank receives the collateral from the Corporation and delivers to the Corporation a check to its order for the amount of the loan being made to the broker.

At all times the collateral is in possession of the one who has parted with funds. The securities and the cash are delivered simultaneously. The bank being paid receives the Clearing Corpo-

ration's draft on parting with the collateral. A draft of the Corporation has essentially the credit characteristics of a bank check, draft, or certified check, which are accepted as cash. When the Corporation delivers the collateral to the new lending bank, the Corporation receives that bank's check.

STOCK CLEARING CORPORATION CONTROL OVER ITS CREDIT TO MEMBER FIRMS

Though the Stock Clearing Corporation, when making payments on behalf of a member firm, comes into possession of securities for the firm, even good market securities are not cash. When a bank makes a loan, the collateral has a market value substantially greater than the amount of the loan; but when the Corporation pays for securities delivered to it for a broker, it pays the full market price, and a slight decline in the market will reduce the value of the securities below the amount paid.

In the course of the day the Corporation not only receives securities and makes payments for the broker, but also delivers securities for the broker and receives payments for them. Nevertheless, at the end of the day the payments it has made for the broker may exceed the payments it has received for him. Even if that is not the case, there may be times during the day when the payments for the broker exceed the receipts for him. The Corporation keeps close watch and control over the credit a member has with it. As a foundation for the credit, the Corporation holds the member's contribution to the clearing fund.

CONTINGENT CREDITS

Early in the day each member must deliver to the Corporation lists of securities to be received through it on that day, for which, therefore, it will be making payments. These lists include (1) balances of securities to be received on the Night Branch clearance, and (2) non-cleared securities to be delivered through the Day Branch. The Night Branch has already verified the balance of cleared securities to be received. For the non-cleared securities, each party to a transaction sends in an exchange ticket compared by them and signed as memoranda of the contract. These tickets constitute a verification by the signature of each party of the delivery to be made, and with them the Day Branch checks the list

of non-clearance securities. So it knows the payments it will be called on to make for a member in the course of the day. These lists of securities to be received and paid are known as "contingent debit lists."

With the contingent debit lists the member also delivers a list of non-clearance securities which the firm will deliver through the Corporation that day. When these deliveries are made, it will collect cash to be credited to the member's account. So such a list is a "contingent credit list." For balances of clearance securities to be delivered by the member at the direction of the Night Branch, the Day Branch does not require a contingent credit list, but simply gives an actual credit when the delivery is made.

FAILURE TO DELIVER

Contingencies of business may cause a failure to deliver or to receive. The parties to the contract may come to an agreement over the matter. If they do not, the broker having the right to performance by receipt or delivery may liquidate the contract by "buying in" or "selling out," as the case may be, and holding the other party for any loss established. In relation to the Stock Clearing Corporation it is the duty of the member failing to deliver or receive to notify the Corporation so that it may correct its list of transactions to be carried through. On such a failure the parties to the contract must settle outside the Corporation.

ACTUAL DEBITS AND CREDITS

When the member sends in the securities he is to deliver, the Corporation enters an actual credit to him on its accounts. And when, as a receiving firm, its messenger takes delivery of the securities it is to receive, its messenger signs and leaves, for each delivery made to it, one of the copies of the charge ticket handed in with the securities comprising the delivery. The Corporation then enters an actual debit in its account with the receiving member.

Throughout the day the Corporation carefully watches the member's credit position. If it is likely to get out of relation to the amount of contribution the member has made to the clearing fund, the Corporation will require the member to bring the credit into the proper relationship by new credits, or a postponement of debits, or by delivery of a certified check.

SETTLEMENT

At the end of the day each member finds out the amount of his final debit or credit balance. If it is a debit, he delivers his check to the order of the Corporation for the amount; and if a credit, draws a draft on the Corporation.

ADDITIONAL SERVICES OF THE STOCK CLEARING CORPORATION

No attempt has been made to present in complete detail the work of the Stock Clearing Corporation. On the contrary, the effort has been to exclude detail in the endeavor to show the general method by which it reduces the work of deliveries and of payments, and reduces the need for resorting to day loans to finance the day's turnover. Its process of handling delayed deliveries has not even been mentioned, but perhaps enough has been said to show the reader that the Corporation can, as it does, handle such deliveries. But some additional services it performs need to be mentioned.

"WHEN ISSUED" CONTRACTS

Sometimes stock is listed before it can be issued and delivered, and contracts are made for delivery "when, as, and if issued." Such a course of dealing may continue for some time. During this period the value of the two sides of the contract may get substantially out of relation. If the contract is made at 90 and the stock goes up to 95, the value of the thing to be delivered is greater than the amount to be paid; and vice versa if the stock should decline to 85. We have seen the process of obviating this risk on the loan of certificates for delivery on short sales by keeping the loan "at market." At the request of the parties to the "when issued" contract, the Stock Clearing Corporation will perform a service in correspondingly reducing the risk by keeping the contract at the market by debits and credits in intermediate settlements, and finally settle by delivery and payment at the price finally reached.

TRANSFER DEPARTMENT

We have seen that brokers transfer into their own name stock they hold for customers in order to collect the dividends for the customer's account. Since such transfers are likely to be requested

just before the day set for making up the dividend list and closing the transfer books, completion of these last-minute transfers is likely to be delayed. In the meantime the broker does not have the certificates available for collateral. The situation may tie up a substantial amount of the broker's funds.

To help in this situation the Stock Clearing Corporation established a Transfer Department. It will receive the certificates to be transferred and issue therefor its own "assignable transfer receipt." Lending banks have agreed to accept these receipts as the equivalent of the stock they represent. The Corporation presents the certificates for transfer, and on receiving the new certificates delivers them to the holder of its receipt on its surrender properly endorsed. If the stock transfer receipt is outstanding more than five days, it is called in and a new receipt issued.

CHAPTER LIV

Federal Regulation of Secondary Markets in Securities

The two acts, the Securities Act of 1933 and the Securities Exchange Act of 1934, present a complete plan for Federal regulation of the securities markets. The Securities Act of 1933 governs the primary marketing of issues; the Security Exchange Act of 1934 governs the secondary markets of the stock exchanges and "over the counter." We have already, in the chapters on the Securities Act (XXXI, XLVIII), considered the Federal supervision of the primary market. This chapter will present an outline of the Federal regulation of the secondary market. It will make no attempt to do anything more than to give a broad general understanding of its scope and operation. For guidance in any specific action the reader must resort to the act itself, the regulations of the Securities Exchange Commission, and such decisions as the courts may have made.

SCOPE OF THE SECURITIES EXCHANGE ACT

Although the title of the Securities Exchange Act seems to limit its scope to the secondary markets of the stock exchanges, the act reaches out to secondary markets off the exchanges, by the authority it confers on the Commission over all brokers and dealers and over the counter markets.

FEDERAL AUTHORITY

In order to show the color of Federal authority, the Securities Exchange Act repeats the formula which the Securities Act has made familiar and provides (Section 5) that:

It shall be unlawful for any broker, dealer, or exchange, directly or indirectly, to make use of the mails or any means or instrumentality of

interstate commerce for the purpose of using any facility of an exchange within or subject to the jurisdiction of the United States to effect any transaction in a security, or to report any such transaction, unless such exchange (1) is registered as a national securities exchange under section 6 of this title, or (2) is exempted from such registration upon application by the exchange because in the opinion of the Commission, by reason of the limited volume of transactions effected on such exchange, it is not practicable and not necessary or appropriate in the public interest or for the protection of investors to require such registration.

And correspondingly Section 15 (a) provides that:

No broker or dealer (other than one whose business is exclusively intrastate) shall make use of the mails or of any means or instrumentality of interstate commerce to effect any transaction in, or to induce the purchase or sale of, any security (other than an exempted security or commercial paper, bankers acceptances, or commercial bills) otherwise than on a national securities exchange, unless such broker or dealer is registered in accordance with subsection (b) of this section.

Jurisdiction over the mails and interstate commerce is relied on to bring these acts within the constitutional authority of the Federal Government. From this footing the Securities Exchange Act reaches out to regulate the secondary markets in securities.

LINES OF CONTROL

As a plan of control the act provides:

(1) Registration and control of exchanges, of dealers and brokers, and of issues listed on exchanges.

(2) Regulation of margin requirements and of loans by banks on security collateral.

(3) Prohibition of manipulation of security prices.

(4) Authority for the Commission to segregate and limit the functions of members of exchanges, brokers, and dealers.

(5) Regulation of the solicitation of proxies.

(6) A requirement that (with such limitations as the act provides) the issuers of new listed issues file periodic reports.

(7) A requirement that the officers and directors of corporations with issues registered on an exchange, and the holders of more than ten per cent of the stock of such corporations, report the amount of their ownership, and each month report changes in the amount of their ownership. This requirement connects with the further provision for recovery by the corporation of unfair profits made by insiders on short term transactions.

(8) A requirement that exchanges, brokers, and dealers keep records and make such reports as the Commission may call for.

Though this outline does not include everything in the act, it gives enough to indicate the essential scheme of regulation. In the matter of proxies the act reaches beyond the supervision of security markets to a regulation of corporate affairs.

REGISTRATION OF EXCHANGES

For registration as a national securities exchange the applicant must file a registration statement, which must include [Section 6 (a)]:

(1) An agreement (which shall not be construed as a waiver of any constitutional right or any right to contest the validity of any rule or regulation) to comply, and to enforce so far as is within its powers compliance by its members, with the provisions of this title, and any amendment thereto and any rule or regulation made or to be made thereunder;

(2) Such data as to its organization, rules of procedure, and membership, and such other information as the Commission may by rules and regulations require as being necessary or appropriate in the public interest or for the protection of investors;

(3) Copies of its constitution, articles of incorporation with all amendments thereto, and of its existing bylaws or rules or instruments corresponding thereto, whatever the name, which are hereinafter collectively referred to as the "rules of the exchange"; and

(4) An agreement to furnish the Commission copies of any amendments to the rules of the exchange forthwith upon their adoption.

Then [Section 6 (d)]:

If it appears to the Commission that the exchange applying for registration is so organized as to be able to comply with the provisions of this title and the rules and regulations thereunder and that the rules of the exchange are just and adequate to insure fair dealing and to protect investors, the Commission shall cause such Exchange to be registered as a national securities exchange.

But [Section 6 (b)]:

No registration shall be granted or remain in force unless the rules of the exchange include provision for the expulsion, suspension, or disciplining of a member for conduct or proceeding inconsistent with just and equitable principles of trade, and declare that the wilful violation of any provisions of this title or of any rule or regulation thereunder shall be considered conduct or proceeding inconsistent with just and equitable principles of trade.

CONTROL OF REGISTERED EXCHANGES

After an exchange is registered, the act confers authority on the Commission to control it in any of the following ways (Section 19):

(1) To suspend or withdraw the registration of the exchange.

(2) To suspend or withdraw the registration of a security on the exchange.

(3) To suspend or expel any member or officer of the exchange.

(4) To suspend trading in a security registered on the exchange.

(5) To change the rules of the exchange:

> *** in respect of such matters as (1) safeguards in respect of the financial responsibility of members and adequate provision against the evasion of financial responsibility through the use of corporate forms or special partnerships; (2) the limitation or prohibition of the registration or trading in any security within a specified period after the issuance or primary distribution thereof; (3) the listing or striking from listing of any security; (4) hours of trading; (5) the manner, method, and place of soliciting business; (6) fictitious or numbered accounts; (7) the time and method of making settlements, payments, and deliveries and of closing accounts; (8) the reporting of transactions on the exchange and upon tickers maintained by or with the consent of the exchange, including the method of reporting short sales, stopped sales, sales of securities of issuers in default, bankruptcy or receivership, and sales involving other special circumstances; (9) the fixing of reasonable rates of commission, interest, listing and other charges; (10) minimum units of trading; (11) odd lot purchases and sales; (12) minimum deposits on margin accounts; and (13) similar matters.

The act, by specific inclusion of matters in which the Commission may exercise control, pretty well covers the list of exchange activities before its omnibus inclusion of "similar matters." In short, if the act is valid, the Commission can take over the running of the exchange. To be sure [Section 6 (f)]:

> An Exchange may, upon appropriate application in accordance with the rules and regulations of the Commission, and upon such terms as the Commission may deem necessary for the protection of investors, withdraw its registration.

But then it may not make use of the mails, or any instrumentality of interstate commerce, and no broker or dealer may make use of its facilities by means of the mails or instrumentality of interstate commerce, unless the exchange is exempted from registration "because in the opinion of the Commission, by reason of the

limited volume of transactions effected on such Exchange, it is not practicable and not necessary or appropriate in the public interest or for the protection of investors to require such registration."

REGISTRATION OF BROKERS AND DEALERS

For the transaction of any business (by use of the mails, etc.) off a registered exchange, brokers and dealers must register. As we have seen, the registration of the exchange brings the doing of business there under the jurisdiction of the Commission. The act reaches the over the counter, or off the exchange, market through the registration of brokers and dealers. The Commission may by its regulations require such information on the broker's or dealer's application to register as it deems "necessary or appropriate in the public interest or for the protection of investors."

Under this authority the Commission has prepared a form of "registration statement for broker or dealer transacting business on over the counter markets." It requires information as to the form of organization under which the business is conducted (sole proprietorship, partnership, corporation), name of proprietor or of partners, or officers and directors, etc. The form then asks, "Does any person not hereinbefore disclosed control the business of applicant?" Presumably this is at least to uncover the identity of a sole or controlling stockholder. What else the question may mean by "control" we will leave as a question open for future interpretation. The blank asks the location of branch offices, the names of their managers, the number of employees of the applicant classified as "salesmen, traders, customer's men, other employees." There follow questions as to the type of business done (broker, dealer), whether credit is extended, and if so, in what form.

Then the inquiry looks into the reputation of the applicant with the following questions:

15. (a) Securities Exchanges of which applicant or any person named in items 5 to 9 is a member. [Items 5 to 9 refer to the managing personnel.]

(b) Has applicant or any person named in items 5 to 9, inclusive, been refused membership or been suspended or expelled from membership by any Securities Exchange?

16. Associations of brokers, dealers, or investment bankers of which applicant is a member.

17. The States in which applicant is licensed to sell securities [i.e., under State Blue Sky Laws].

18. Has registration or license of applicant or of any person named in items 5 to 9, inclusive, been refused or revoked in any State? ***

19. (a) Has applicant or any person named in items 5 to 9, inclusive, within the last 10 years, been a director, officer (or person occupying similar status or performing similar functions), partner, or branch office manager of any other broker or dealer, or a person controlling the business of any other broker or dealer? [If so, the facts are to be set forth.]

(b) Was the registration or license of such other broker or dealer refused or revoked in any State during the period of such connection? [If so, the facts are to be set forth.]

20. Has applicant or any person named in items 5 to 9, inclusive, within the last 10 years, been convicted *** of any felony or misdemeanor involving the purchase or sale of any security, or arising out of the conduct of the business of a broker or dealer? [If so, the facts are to be set forth.]

21. Is applicant or any person named in items 5 to 9, inclusive, permanently or temporarily enjoined on the date hereof, by order, judgment or decree of any court of competent jurisdiction entered within the last 10 years from engaging in or continuing any practice in connection with the purchase or sale of any security? [If so, the facts are to be set forth.]

22. Has any person named in items 5 to 9, inclusive, used or been known by any other name? [If so, the facts are to be set forth.]

It will be noted that the qualifications rest on character alone. The act makes no attempt towards anything in the nature of other professional qualifications in knowledge and experience. As far as the act goes, the occupation of security broker or dealer is open to the Emersonian tin peddler Yankee. This remark is not intended to indicate a belief that the requirement should or should not be otherwise.

Unless the Commission denies the application for cause as set forth in the act, the registration becomes effective thirty days after receipt of the application. Correspondingly, for cause the Commission may revoke a registration after it has become effective. In either case the Commission acts only after an opportunity is given the broker or dealer for a hearing.

REGISTRATION OF LISTED ISSUES

The Securities Exchange Act provides, in Section 12:

(b) A security may be registered on a national securities exchange by the issuer filing an application with the exchange (and filing with the

Commission such duplicate originals thereof as the Commission may require), which application shall contain —

(1) Such information, in such detail, as to the issuer and any person directly or indirectly controlling or controlled by, or under direct or indirect common control with, the issuer, and any guarantor of the security as to principal or interest or both, as the Commission may by rules and regulations require, as necessary or appropriate in the public interest or for the protection of investors, in respect of the following:

(A) the organization, financial structure and nature of the business;

(B) the terms, position, rights, and privileges of the different classes of securities outstanding;

(C) the terms on which their securities are to be, and during the preceding three years have been, offered to the public or otherwise;

(D) the directors, officers, and underwriters, and each security holder of record holding more than 10 per centum of any class of any equity security of the issuer (other than an exempted security), their remuneration and their interests in the securities of, and their material contracts with, the issuer and any person directly or indirectly controlling or controlled by, or under direct or indirect common control with, the issuer;

(E) remuneration to others than directors and officers exceeding $20,000 per annum;

(F) bonus and profit-sharing arrangements;

(G) management and service contracts;

(H) options existing or to be created in respect of their securities;

(I) balance sheets for not more than the three preceding fiscal years, certified if required by the rules and regulations of the Commission by independent public accountants;

(J) profit and loss statements for not more than the three preceding fiscal years, certified if required by the rules and regulations of the Commission by independent public accountants; and

(K) any further financial statements which the Commission may deem necessary or appropriate for the protection of investors.

(2) Such copies of articles of incorporation, by-laws, trust indentures, or corresponding documents by whatever name known, underwriting arrangements, and other similar documents of, and voting trust agreements with respect to, the issuer and any person directly or indirectly controlling or controlled by, or under direct or indirect common control with, the issuer as the Commission may require as necessary or appropriate for the proper protection of investors and to insure fair dealing in the security.

(c) If in the judgment of the Commission any information required under subsection (b) is inapplicable to any specified class or classes of issuers, the Commission shall require in lieu thereof the submission of such

other information of comparable character as it may deem applicable to such class of issuers.

(d) If the exchange authorities certify to the Commission that the security has been approved by the exchange for listing and registration, the registration shall become effective thirty days after the receipt of such certification by the Commission or within such shorter period of time as the Commission may determine. A security registered with a national securities exchange may be withdrawn or stricken from listing and registration in accordance with the rules of the exchange and, upon such terms as the Commission may deem necessary to impose for the protection of investors, upon application by the issuer or the exchange to the Commission; whereupon the issuer shall be relieved from further compliance with the provisions of this section and section 13 of this title and any rules or regulations under such sections as to the securities so withdrawn or stricken.

An unissued security may be registered only in accordance with such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors. Such rules and regulations shall limit the registration of an unissued security to cases where such security is a right or the subject of a right to subscribe or otherwise acquire such security granted to holders of a previously registered security and where the primary purpose of such registration is to distribute such unissued security to such holders.

Since the act does not exempt from its registration requirements issues which for their primary marketing have been registered under the Securities Act of 1933, the listing of such issues must also be registered under the Securities Exchange Act. For issues registered under the Securities Act of 1933 the Commission may, however, extend unlisted trading privileges. Section 12 (f) (3) provides that the Commission:

*** may extend unlisted trading privileges to any security in respect of which there is available from a registration statement and periodic reports or other data filed pursuant to rules or regulations prescribed by the Commission under this title or the Securities Act of 1933, as amended, information substantially equivalent to that available pursuant to rules or regulations of the Commission in respect of a security duly listed and registered on a national securities exchange, but such unlisted trading privileges shall continue in effect only so long as such a registration statement remains effective and such periodic reports or other data continue to be so filed.

It would seem that the amount of duplication involved in two statements might be obviated for admission to full listed trading privileges.

UNLISTED TRADING PRIVILEGES

We have just referred to unlisted trading privileges. An exchange may have permitted trading in an issue without its having been fully listed on compliance with all the requirements of the exchange for listing. From 1885 to 1910 the New York Stock Exchange had such an unlisted department.[1] The New York Curb Exchange still admits certain unlisted issues to trading.

All corporations putting out new issues will have to furnish the full information about their affairs required for registering the issues under the Securities Act. We have already indicated the reasonableness of admitting such issues to trading on the exchanges. As we have seen, even this is not automatic, but only with the consent of the Commission. But should all the existing issues, which have gone through the process of primary distribution before the enactment of this legislation, be excluded from trading on the exchanges unless they comply with the full requirements for registration? To exclude them on failure to register would be to destroy an existing secondary market to the injury of their holders.

The act makes express provision for trading without registration under three sets of circumstances:

(1) Issues admitted to unlisted trading before March 1, 1934. (The act was approved June 6, 1934, and went into effect July 1, 1934, except as to parts which it made effective as of later dates.)

(2) Issues fully registered on one exchange, but also traded in on another exchange without listing there.

(3) Issues for which information has been given by registration under the Securities Act.

It is noted that these classes do not include any issues already listed on the exchange at the time of the passage of the act. One surmises that the draftsmen assumed that corporations which had already complied with listing requirements of the exchange would comply with the registration requirements of the act, and that investors would continue to have the benefit of the exchange market.

It is to be noted that a security admitted to the privilege of unlisted trading is nevertheless a registered security for the purpose of the application of the act.

[1] J. Edward Meeker, *The Work of the Stock Exchange*, Revised Edition, pp. 71, 72.

REGULATION OF MARGIN REQUIREMENTS AND OF LOANS BY BANKS

The chapter on long and short transactions has already presented the provisions of the act relating to margin requirements and loans by banks, and this chapter will not deal with them further.

PROHIBITION OF MANIPULATION OF SECURITY PRICES

Section 9 of the act reaches beyond the exchanges and brokers and dealers for control of the secondary markets, and makes it unlawful for *any person* "directly or indirectly by use of the mails or any instrumentality of interstate commerce, or of any facility of any national securities exchange" to engage in various manipulative practices.

Note that the act makes the practices "unlawful." It substantially creates of them a statutory tort, and makes one who commits the tort "liable to any person who shall purchase or sell any security at a price which was effected by such act or transaction," who "may sue in law or in equity in any court of competent jurisdiction to recover the damages sustained ***."

So the act makes it unlawful:

For the purpose of creating a false or misleading appearance of active trading in any security registered on a national securities exchange, or a false or misleading appearance with respect to the market for any such security,

(A) to effect any transaction in such security which involves no change in the beneficial ownership thereof, or

(B) to enter an order or orders for the purchase of such security with the knowledge that an order or orders of substantially the same size, at substantially the same time, and at substantially the same price, for the sale of any such security, has been or will be entered by the same or different parties, or

(C) to enter any order or orders for the sale of any such security with the knowledge that an order or orders of substantially the same size, at substantially the same time, and at substantially the same price, for the purchase of such security, has been or will be entered by or for the same or different parties.

Rules of the New York Stock Exchange (and presumably of other exchanges) strictly forbid its members from engaging in fictitious transactions, and the New York Penal Law (and pre-

sumably, or very likely, the law of other States) makes fictitious transactions in securities a criminal offense.

Subdivision (A) of Section 9 (1) just quoted deals with such strictly fictitious transactions in which there is no actual change in beneficial ownership. A price is created not based on any actual shift of risk by anybody. But the speculator, through his two brokers, may buy from A and sell to B. The transactions are genuine. A sells shares and B acquires them. They change their risk even though the speculator does not. However, it may well chance that with such orders the two brokers, though quite unaware of the common origin of their orders, may deal with each other. In that case there would be no actual change in beneficial ownership. In either case the speculator without really assuming economic risks creates a market activity, which the observer may interpret as arising out of economic causes.

Further the act makes it unlawful:

> To effect, alone or with one or more other persons, a series of transactions in any security registered on a national securities exchange creating actual or apparent active trading in such security, or raising or depressing the price of such security, for the purpose of inducing the purchase or sale of such security by others.

Manipulative transactions would defeat themselves unless they succeeded in bringing the public in. Purchases of a large number of shares of a given issue would ordinarily put the price up. At that point the books of the speculator or speculative pool, with acquisitions inventoried "at market," would show a profit. To convert that "profit" into cash the stock must be sold, and the selling operation would tend to depress price as much as the buying operation had raised it. The liquidating losses would nullify the acquisition profits. If, however, the rising price induces others to come into the market and buy, they may continue buying after the manipulator begins to sell, so that the manipulator's sales do not actually lower price, though they retard the rise, and he is able to make an actual cash profit.

One might say, "What of it?" The "outsider" has his opportunity to consider the situation and arrive at a conclusion as to whether or not the underlying values are such as to justify the price, and if he pays more than his stock is worth, that is his lookout. But there is a social interest in having markets "free" in the sense that the prices made represent the result of economic forces and to the extent that they show a resolution of the opinions of

buyers and sellers as to the strength of those forces. Our economic activity involves enough hazards that are necessary. It is an endeavor of society to reduce these hazards. We do not want artificially created, and therefore unnecessary, hazards entering into our economic life. The speculator who does not manipulate fulfils the useful function of taking over risks that others wish to shift. A manipulative speculator creates an additional hazard of false appearances.[1]

Also the act makes it unlawful:

(1) For a dealer or broker to induce the purchase or sale of a security by predicting a rise or fall in its price;

(2) For a broker or dealer to induce the purchase or sale of a security by making a false or misleading statement;

(3) For anyone, on a consideration received from a broker or dealer, to predict a rise or fall in the price of a security as a result of manipulative operations;

(4) To peg prices in contravention of rules and regulations of the Commission.

Further, the act confers on the Commission the regulation of options — puts, calls, straddles — stop loss orders, and short sales.

And, generally, the act makes it unlawful for any person:

> To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

A possible inference from the language that the Commission may authorize some "manipulative or deceptive" devices seems mildly amusing; but perhaps such authorization is actually intended in order to cover distribution syndicate price pegging.

The usual jurisdictional phrase about using mails or instrumentalities of commerce for these purposes accompanies the prohibitions.

In our consideration of security syndicates we saw the necessity, under the American practice of distribution, for pegging the market price while the syndicate operation continues. Obviously such a pegged price presents an aspect of manipulation. The

[1] *The Security Markets*, Twentieth Century Fund, Inc., New York, 1935, in Chapter XIII presents a consideration of manipulative practices.

market is not "free" as long as the price is pegged. In view of the established process of distribution the framers of the act did not include a prohibition of pegging, but left its regulation to the Commission. Possibly also the political ideas of the administration in power, as represented in other matters, included the idea of a *justum pretium*, and the belief that the maintenance of a just price, even by force, is not an economic sin, but an economic virtue.

SEGREGATION OF FUNCTIONS OF DEALER AND BROKER

If a man acts both as broker and dealer, conflicts may arise between his interests as a dealer and the interests of one for whom he acts as broker. Since the relationship of principal and agent is fiduciary in character, and an agent may not properly take a position in a transaction in which his interests would be adverse to those of his principal, the Common Law affords substantial protection to the customer. Rules of the exchange express the principle, at least in part. Still, the ideal would be for men who act as brokers not to engage in transactions at all on their own account. However, the possible damage of disrupting an existing course of business, developed out of antecedent conditions, by an absolute prohibition of a broker from dealing on his own account presumably outweighs the additional protection of the customer such a prohibition would afford. So the act merely authorizes the Commission to intervene with regulations.

In one respect the act becomes mandatory, and provides [Section 11 (d)] that:

> It shall be unlawful for a member of a national securities exchange who is both a dealer and a broker, or for any person who both as a broker and a dealer transacts a business in securities through the medium of a member or otherwise, to effect through the use of any facility of a national securities exchange or of the mails or of any means or instrumentality of interstate commerce, or otherwise in the case of a member, (1) any transaction in connection with which, directly or indirectly, he extends or maintains or arranges for the extension or maintenance of credit to or for a customer on any security (other than an exempted security) which was a part of a new issue in the distribution of which he participated as a member of a selling syndicate or group within six months prior to such transaction: Provided, that credit shall not be deemed extended by reason of a bona fide delayed delivery of any such security against full payment of the entire purchase price thereof upon such delivery

within thirty-five days after such purchase, or (2) any transaction with respect to any security (other than an exempted security) unless, if the transaction is with a customer, he discloses to such customer in writing at or before the completion of the transaction whether he is acting as a dealer for his own account, as a broker for such customer, or as a broker for some other person.

One surmises that participation within six months in a syndicate transaction will be interpreted to mean within six months of the close of the syndicate and not six months from taking the participation. In short, temptation is to be removed from a dealer pressing the sale of securities of an issue, in the distribution and market action of which he has an interest, by utilizing the margin facilities of exchange transactions. The second part of the provision requiring a disclosure of interest, and therefore presumably involving the consent of the customer, seems no more than the Common Law requirement that an agent shall not have an interest adverse to his principal, except that the act requires the evidence of the disclosure in writing.

SOLICITATION OF PROXIES AND CONSENTS

As we have remarked, the act, in dealing with the solicitation of proxies, reaches beyond the securities markets and into the regulation of corporate affairs. Section 14 provides that:

(a) It shall be unlawful for any person, by the use of the mails or by any means or instrumentality of interstate commerce or any facility of any national securities exchange or otherwise to solicit or to permit the use of his name to solicit any proxy or consent or authorization in respect of any security (other than an exempted security) registered on any national securities exchange in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

(b) It shall be unlawful for any member of a national securities exchange or any broker or dealer who transacts a business in securities through the medium of any such member to give a proxy, consent or authorization in respect of any security registered on a national securities exchange and carried for the account of a customer in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Regulations promulgated under this section are stated not to apply to various classes when no remuneration is paid for the

solicitation. The exemptions pretty well let out those who in the ordinary course of affairs might be soliciting, except the corporate management itself. If anyone receives compensation, however, it is to be noted that he is not exempt from the regulations. These provide that anyone soliciting must furnish information disclosing the initiator of the solicitation, the payment of compensation, and the action intended to be taken on the exercise of the proxy or consent. This brief statement does not show the full requirements, but indicates the tenor of the regulation.

If the issuer or its management solicits, then on the request of any security holder of record, who prepays the cost, or gives security for such payment, the issuer must mail such form of proxy and letter as the security holder may furnish for mailing.

The point is this: on the solicitation of proxies the management has an advantage over a security holder who is not in the management. It has possession of the records and knows who the holders are and their addresses. To be sure, a stockholder has a certain right of access to the stockholder list, but presumably this right does not extend to lists of holders of other registered securities of the corporation. But even assuming that the management makes no difficulties in giving a stockholder access to the list, he has a laborious task to perform in drawing it off. Access to the list gives him no right to run it off on the corporation's addressograph. The regulation seeks to place him on a parity with the management for convenience of access to his fellow stockholders.

It is to be noted, however, that the regulations require this mailing to "every record holder of each class of security, any of the holders of which have been or are being solicited by the management." One assumes that the holder of a bearer security, as a coupon bond, is not a "record holder." Yet through income tax certificates attached to coupons for collection the corporation may have lists of the holders of bearer securities, and be able to solicit them. Perhaps the situation might be completely covered by requiring the management to send out for a security holder his form of proxy and letter to all whom the management has solicited.

REPORTS

We find the act dealing in two places with the requirement of periodical reports of corporations. Section 13 relates to reports of issuers of securities registered on a national securities exchange;

and Section 15 (b) to reports of corporations filing registration statements under the Securities Act of 1933. This latter is essentially an amendment of the earlier act, and would be better placed if expressly so made.

Every issuer of a security registered on a national securities exchange must file periodical reports with the exchange and duplicate originals with the Commission (in accordance with such rules and regulations as the Commission may prescribe as necessary or appropriate for the proper protection of investors and to insure fair dealings with the security). The Commission may require information and documents to keep the registration statement reasonably up to date; and may require that annual reports be certified by independent public accountants.

Happily for the managers of enterprise already harassed with accounting requirements, the act provides that "in the case of the reports of any person whose methods of accounting are prescribed under the provisions of any law of the United States, or any rule or regulation thereunder, the rules and regulations with respect to reports shall not be inconsistent with the requirements imposed by such law or rule or regulation in respect of the same subject matter." Of course States having jurisdiction may make any accounting requirements they see fit. Further the Commission shall permit carriers reporting to the Interstate Commerce Commission to file duplicates with the Exchange and the Securities Exchange Commission in lieu of other reports.

The express authority for imposing accounting methods [Section 13 (b)] is of such interest that it is quoted:

> The Commission may prescribe, in regard to reports made pursuant to this title, the form or forms in which the required information shall be set forth, the items or details to be shown in the balance sheet and the earning statement, and the method to be followed in the preparation of reports, in the appraisal or valuation of assets and liabilities, in the determination of depreciation and depletion, in the differentiation of recurring and non-recurring income, in the differentiation of investment and operating income, and in the preparation, where the Commission deems it necessary or desirable, of separate and/or consolidated balance sheets or income accounts of any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer; ***

Section 15 (d) deals with issuers filing registration statements under the Securities Act of 1933, and so reaches with reporting and

accounting requirements corporations which may not list their securities on an exchange. It provides that they shall present as part of the registration statement an undertaking to file "such supplementary and periodic information, documents and reports as may be required pursuant to Section 13 of this title in respect of a security listed and registered on a national securities exchange." The provision limits the requirement, however, to the cases of issues having an aggregate sale price of $2,000,000 or more. No corresponding limitation appears for listed issues. Presumably it was deemed improbable that many issues of lesser magnitude would be listed on a national securities exchange. Operation of the act does not impose a duplication of filing. If, and as long as, the issue is registered on a national securities exchange, and therefore comes under the information requirements arising thereunder, the requirement of information under Section 15 (d) is suspended.

In accordance with the act, the Commission has prepared reporting forms for various types of enterprise.

INFORMATION REQUIRED OF DIRECTORS, OFFICERS, AND HOLDERS OF TEN PER CENT OF STOCK AND LIMITATIONS PLACED ON THEM

One of the especially interesting provisions of the act requires every officer and director of a corporation and every holder of ten per cent of its stock to report the amount of ownership, and monthly to report changes in the amount [Section 16 (a)].

If such a person makes unfair use of information obtained by reason of his relationship to the corporation to profit by transactions in its stock, the corporation may recover "any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) within a period of less than six months *** irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months" [Section 16 (b)].

Directors, officers, and such principal stockholders may not make short sales in the issues of their company. They may not even make sales "against the box" unless followed by delivery from the box within the time limited by the act [Section 16 (c)].

The provision against making unfair use of inside information

touches an evil of corporate affairs. We still have to learn what, under the act, will be held to be an unfair use. Any use by an insider of information not yet available to all members of a corporate group affected is unfair in a sense. On publication it ought to be deemed available to all. An insider ought not to be prevented from acting on his own account until he knows that the information has actually entered the mind of all whom it affects.

On the other side of the question of the unfairness of officers, directors, and larger stockholders who have access to advance information and make use of it to their advantage is the fact that their purchases (or sales, as the case may be) may tend to cushion and correct the market. The act as it stands, and perhaps in any way in which it could be revised in this respect, must largely prevent insiders from undertaking any short term transactions at all, even though not based on any information not possessed by the world at large, for fear that their profits may be held unfair. Transactions by insiders on the long side, expressing confidence in the enterprise, serve as a correction for market underpricing, and on the short side as a correction for overpricing. The course of the stock market in October, 1937, challenges the soundness of some of the theories on which the act is based.

Prohibition of short sales or sales against the box presents more of a puzzle as to why it should be included. The act gives evidence that men having a knowledge of speculation took part in its drafting. Unless an insider makes an unfair use of inside information, why is it any more heinous for him than for anyone else to sell short? Apparently someone insisted on dragging the bogey of short selling as such into the measure. There is a persistent idea that all short selling is iniquitous.

"Selling against the box" perhaps should have some explanation at this point. A man who owns a security (and therefore has it in his safe deposit box) may cause his broker to make a short sale, that is, a sale which is "short" in the sense that the broker has to borrow to make delivery within the time set by the rules of the exchange. He may do this simply to hedge his long position. Of course, if he is "short," yet has stock to deliver to cover, he gains no advantage by either a rise or a fall in price. He is essentially in the position he would be in if he sold his stock and owned none. He may, however, consider it psychologically better for him to hedge as expressing a greater probability of resuming a long position.

Men often make sales against the box for mere convenience. A New York resident may decide to liquidate a certain stock holding while he is in Chicago on a business trip. His stock certificate is in his safe deposit box in New York. He may telegraph to his broker to sell short and indicate that he will cover later by delivering his own stock.

CHAPTER LV

Speculation

Our concern with the secondary markets for securities lies primarily with the foundation they afford for the financing of enterprise. Current economy has developed the group form of carrying on the processes of production, and, in a lesser degree, of marketing. And the group form, through the device of the corporation, makes ownership fungible. One share of stock of a given issue, or one bond of an issue, represents an ownership of exactly the same values as any other share of stock or any other bond of the issues. With this fungible ownership we have possible the development of a market for capital. Through the mechanisms of the stock exchange the development reaches the maximum that markets have attained.

Such a market has an important social utility. It enlarges the boundaries of individual action. Through it the individual can rapidly convert ownership into cash, and with the cash be completely free to consume wealth or to hazard a venture of new economic fortunes. He can make a daily — hourly, if he wishes — appraisal of risks, and shift them in accordance with his judgment. In the active issues he can ordinarily, and even in times of considerable stress, buy an eighth of a point above the last sale, or sell an eighth below. On a one hundred share transaction, with a sale just made at $97 a share he can sell for $9687.50 or buy at $9712.12, a $25 difference on an amount of nearly $10,000. And his cost of brokerage will be only $20. All the buyer or seller has to do is to say the word to his broker. The contract will be made in a few minutes, and in regular course the principal will have his cash in two days. If he is in a hurry, he can make a "cash" sale, at a slight sacrifice in price, and get his money the same day. Such a market affords opportunity for abuse, and abuses develop. Even when the sons of God came to present themselves before the Lord, Satan came also among them.

GAMBLING

In terms of the law, gambling consists of taking a risk which is created for the purpose of being taken; so there is no shifting of an existent risk. If A and B are two mere onlookers at a horse race, and A bets B that a certain horse will win, A had no risk in the race until he created one by his bet, and neither had B. So if A bets B that the price of X stock will be higher at the close of the exchange one week from date, and they agree to settle the bet by B paying A the amount of advance on one hundred shares or A paying B the amount of decline on one hundred shares, neither A nor B is buying or selling X stock. They are not concerned with the element of existent economic risk, and their agreement is a gambling one. The Common Law refuses to give gambling agreements the status of contracts. They are unlawful and unenforceable. We are not here concerned with any statutory interferences which make gambling, or some types or aspects of it, a criminal offense.

In connection with security transactions the law test lies in the right of delivery. If the contract creates a seller-buyer relationship, with a right on one side to receive and on the other to deliver, we do not have a gambling agreement. To be sure, the parties, after creating this right of delivery, may subsequently agree to settle without delivery, and may liquidate their rights on the basis of change in price. But the economic risk of the price of the stock existed, and this risk had been assumed by the contract. The fact that the parties subsequently agreed to settle without delivery is not material. The fact of the subsequent cash settlement may cast suspicion on the original agreement, may raise a question whether it really was for any actual delivery. If, however, it was in fact a delivery contract, it was not a gambling agreement.

For the purposes of the law the distinction is sound. From the viewpoint of ethics outside the field of the law, people sometimes use the word "gambling" in a different sense, often vaguely. The connotation then is that of a reckless taking of risks without any real knowledge of their nature and extent. The essential ethical values involved lie in whether or not the risks are greater than one ought to assume, in view of all one's circumstances; and this involves a rational consideration of the nature and extent of the risk. One may conceivably also have a viewpoint

that sees as unethical the creation of any risk, as with gambling in the law sense, in a world in which necessarily existing hazards are so great.

BUCKETING

One of the recurrent evils accompanying the stock exchange markets with their published quotations is the outcropping of bucket shops. In a bucket shop the ostensible brokers take orders from customers, but do not fill them. Bucket shops carry the customer's account as though it were an actual brokerage account, and if they are to stay in business must settle with the customer on the basis of nominal profit or loss in the account. Obviously the interest of the broker is directly adverse to the interest of the customer. The broker is, in effect, betting against his customer.

Doubtless many of the customers of bucket shops are perfectly aware of the nature of the enterprise being carried on, and are content to be laying bets. Since the fall of 1929 amateur speculation has not been so popular as it had been earlier. From time to time better business bureaus and district attorneys have been watchful for bucketing, and one feels that the evil is quiescent. Formerly the acceptance of lower margins than a genuine broker would take would indicate probable bucketing to the sophisticated. For those who know they are dealing with a bucket shop, and are placing bets, the situation presents no more aspects of undesirability than other forms of betting.

Inexperienced people, however, may not be aware that they are dealing with a bucket shop, and for the unwary the situation is sinister. If they had been dealing with a legitimate broker, they, on paying their debtor balances, could reclaim their securities in the event of an insolvency of the broker. Moreover, a genuine broker is not so likely to become insolvent as a bucket shop keeper. If the broker confines himself to a commission business, his affairs, diligently attended to, possess an excellent degree of safety. To the extent that he undertakes the hazards of defalcational speculation, he opens the way to a possible insolvency.

Since the bucket shop keeper has bet against his customer, has not actually bought or sold on his customer's order, the bucketer can win only if his customer loses. So it is the interest of the bucketer to have the customer lose, to keep him speculat-

ing until the losses in the account justify closing the customer out, and to that end to give the customer, not the best, but the worst advice.

Laws of the States make bucketing criminal; and these laws do all that laws can do to abate the evil. Further, only the watchfulness of law enforcing authorities and of those interested in legitimate business can protect the unwary.

SPECULATION AND INVESTMENT

Probably few words are used more frequently as expressing opposed ideas than the words "investment" and "speculation." And when so used the substance of their meaning is in general sufficiently understood. Yet the things themselves merge into each other in practice, and men often fall far short of precision in thinking and speaking of them.

Speculation endeavors to make profits out of changes in price. It does not matter that price changes are up or down. An adequate mechanism for taking advantage of a fall in price may not exist, but if it does, as in the case of short sales on the stock exchange, or in situations permitting contracts for future deliveries, speculation may be for the fall as well as for the rise.

Investment aims at two things: (1) to postpone for future enjoyment of a right of present consumption, and (2) through a commitment as capital of the wealth, over which the present right exists, to gain some part of the increase in production due to the use of the capital. Perhaps in our thinking about investment we generally tend to overemphasize the second factor, the potentiality of greater aggregate consumption, the benefit of income as well as of principal, arising out of refraining from immediate consumption. The possibility of a commitment on terms the reverse of interest has already been mentioned. Some at any rate would be willing to refrain from consuming now if they could have adequate assurance of being able to consume in the future an amount even less than they have a present right to consume.

In practice the difficulty of distinguishing between investment and speculation lies in the fact that the two things are seldom completely separated. The investor often makes a profit or a loss. Sometimes he has an intent to make a profit, if he can; and, even if there is no intent, profits and losses arise in the course of his transactions. Income in the sense of receiving some

part of the production due to the use of capital may accrue in the course of a speculation. The best we can do with definition is to say that the primary purpose of the speculator is to make profits, and the primary purpose of the investor is to postpone consumption and share in the productivity of capital.

BOTH SPECULATIVE AND INVESTMENT TRANSACTIONS MAKE THE MARKET

For an investor wishing to liquidate a particular commitment the intent of the buyer, whether he be investment or speculation minded, makes no difference. In either case the present owner gets what he wants, a conversion of his risk in the enterprise into the risk of cash. It is important for the owner, a thing of value to him, (1) that someone should be ready to make a bid for his security; and (2) that more than one potential buyer should be ready to bid. It is not enough that there should be one buyer; the seller needs competitive buyers in order to get a price representing a close estimate of value. If the bidders are numerous enough to result in a price representing a resolution of opinions on value, the seller has an adequate market. And of course a buyer needs competitive sellers as much as a seller needs competitive buyers.

If an investor has a market in which the number of buyers and sellers is sufficient to make a quick close price, he has all the values that a market can have for him. On the stock exchange, where by the rules bids go by one-eighth of a point, if an investor can buy or sell at any time one-eighth away from the last sale, he has as good a market as the stock exchange can give him. The services of brokers on the stock exchange are non-competitive in terms of compensation. The rules fix the "union rates." The fact that an even closer market can be made off the exchange than on it in bonds takes to the over the counter market most of the dealings in listed bonds.

Participation of speculators in the stock market up to the point of maximum quickness and closeness has a social utility; beyond that point it has none. Speculation in commodity markets serves other useful functions. But it is individual advantage and not social benefit that motivates speculators. It is not to be expected that they will cease speculating in what, from a social viewpoint, is an issue active to an unnecessary extent, and

transfer their speculations to an issue not sufficiently active, just because of the social benefit.

Granting that speculative transactions make a market just as much as those of investors, and that to the extent necessary to attain maximum speed, closeness, and relative stability, they have utility, question arises as to whether they have offsetting disadvantages. One of the classical defenses of speculation is that it stabilizes the market. It is easy to argue that the speculator's sales slow its upward movement and his purchases its downward movement. This might be the case if speculation were entirely professional, engaged in only by men who are shrewd judges of value, and also if opinion of value were always the major determinative force in the market.

But things other than opinion of value in view of all the existing economic conditions enter into the making of a market. A speculator is concerned with changes in price and with value only as possibly a norm towards which eventually price will tend. If the speculator believes prices will go up or down in spite of his opinion of value, he will make his commitments accordingly, and they will push the market still further away from the norm instead of stabilizing it. To be sure, he will eventually have to liquidate his position, and his liquidating transactions will be counteractive to the preceding trend. But it is not stabilizing the market to send it a long way back. Then, too, it is a constant hope of the speculator that unintelligent opinion will force the market further on its trend, and permit him to complete his liquidation without creating a contrary price movement, though his transactions may retard or halt the existing trend.

AMATEUR AND PROFESSIONAL SPECULATION

Speculators range all the way from those who look on the stock exchange as a convenient American substitute for Monte Carlo to astute shrewd gentlemen skilled in the knowledge and observation of market forces, and intuitive about them as well, who use their skill and intuition to guide their transactions. To many the stock exchange opening is the equivalent of the croupier's "Faites vos jeux, Messieurs." Some of the same phenomena appear in the Street as in the Casino. The stock exchange breeds "systems" even more prolifically than the gaming table breeds them.

Much more numerous than those who would confess themselves gamesters, however, are those who, in their transactions, believe they are using knowledge on the most unsubstantial foundation for such a belief. Economic forces of the world, money, credit, the foreign exchanges; the influences affecting a type of industry; the conditions within a particular enterprise; politics, domestic and foreign; the unstable psychology of investors and speculators reacting to these influences — all these things enter into the making of prices on the stock exchange. Yet when the "public" is "in," the man who is proudly able to read the column of quotations in the newspaper, who can deduce business trends from the fact that his neighbor has bought a refrigerator, who has picked up a little patter about the "technical position" of the market, thinks that he is speculating intelligently.

During a prolonged bull movement the customer's room of a commission brokerage firm with a numerous clientele presents an interesting group of human beings. A jobber in some staple, who by shrewd diligence and untiring energy has built up a fortune of a quarter of a million or more, may be haunch and jowl beside an ex-taxi driver in search of a larger life with his stake. A stenographer, whose typing may be nothing to brag about, in some minutes of her luncheon hour peeps at the board around the elbow of a contractor who is quite aware of the painfulness of losing money in his own highly speculative occupation. A clerk has stolen a few minutes of time to come in and feel the tape slip through his fingers. Customer's men are taking telephone orders from offices where employees speak furtively through cupped hands into the instrument; the possibility of a point or two on twenty-five shares is far more exciting than the weekly salary for making entries in the books.

With the requirement of larger margins probably some of these people will not be in the next bull market. Very likely some brave bucketer will hazard the statutory penalty of imprisonment to accommodate a few of those absent from the legitimate commission office. But the jobber, the contractor, and others of like economic status will be there, and borrowing the limit. If the market falls, will they be able to respond to margin calls? And will not the effect in forcing down prices be the same on failure to respond to calls to keep a margin up to, say, forty per cent as it is on failure to keep a margin up to ten or fifteen per cent?

Men have a right to pursue happiness — so the Declaration of Independence proclaims. Though truths which rest on self-evidence are open to the suspicion that no other evidence can be adduced in their support, one may assume that humanly society should not impose a prohibition on the amateur who pursues happiness through speculation. One might wish he did not so often cry "ai, ai," and impute the blame to the social order, when the happiness pursued eludes him. Nevertheless, it would probably be well for the security markets if only professionals engaged in active speculation.

A man who takes up speculation as his occupation needs a temperament adapted to it — as, indeed, any occupation has its temperamental prerequisites for success. A speculator needs to recognize that losses will be frequent and probably large. He must be so constituted as not to worry about them, or let them affect his judgment. They must be just part of the day's work. If the speculator makes his gains exceed his losses, he is successful. His gains will not elate him or interfere with his judgment any more than his losses. This day, this week, this month, or even this year has been good; but losses will come. He must keep emotion from flooding his mental machinery.

The writer has at various times seen men conduct hypothetical speculation successfully. It is not difficult to set up conditions for hypothetical commitments closely approximating those of actual transactions. They can be so imposed that cheating in the game of speculative solitaire is impossible. Under such conditions the writer has seen men conduct hypothetical operations over substantial periods of time with largely preponderating profits. He has seen these same men then put in funds for actual commitments. Immediately, or soon, their actual operations resulted in such substantial losses as not to justify their continuance. Imaginary profits or losses do not much stir the emotions. They do not create a psychological condition interfering with judgment. But even when the money is other people's money, if the change of a point in price means a profit or loss of $100 on a single one hundred share commitment, the glasses through which the ordinarily human speculator looks are colored. The market looks different.

Probably few, if any, professional speculators attempt to take into account all the influences affecting the market. To take them all fully into account, and fairly estimate their relative

importance at the moment, would be almost, probably quite, humanly impossible. The speculator elects to operate for the shorter or the longer swings, and to estimate what he believes to be the predominant forces causing those swings.

If the only speculators were professionals, they would not have the vast bulk of amateur speculative commitments to work with. Such speculators count on the public, whether speculative or investment, coming into the market to carry along its movements and enable them to liquidate their long or short positions without loss. Participation of the investment public in the market is slower than that of the amateur speculators. Its participation does not pile up such masses of transactions. Reluctant as one may be to say that men should be prohibited from buying stocks on thin margins while they are left quite free to buy refrigerators, cars, and houses with little more than a dollar down, one surmises that the present statutory stock margin requirements will reduce the amount of amateur speculation, improve the tone, and reduce the risks of the market.

TECHNICAL POSITION OF THE MARKET

Our amateur speculator feels a gratifying sense of sophistication in using the phrase "technical position of the market." Its meaning is simple enough, however. If for a period speculative operations have been predominantly for the rise, speculators, to realize profits, or to reverse their position, or to withdraw for a time from the market, must sell. They do not buy securities to hold for income, but to profit by price change. When they liquidate a long position, their realizing sales will tend to put the market down. Under such circumstances the market is in a technically weak position. Potential liquidation of holdings overhangs the situation.

Conversely, if the speculative operations for a time have been predominantly for the fall, that is, if speculators have sold short in greater volume than they have bought, their covering operations will tend to advance prices. The market is technically in a strong position.

This is a very simple statement of intricate market phenomena. Speaking broadly, all short sales are speculative, and presumably one can feel more confidence that the market is in a technically strong position consequent on short selling than one can feel that

it is in a weak position consequent on buying. The shorts will cqver. But buying may have been for investment, and liquidation may not follow.

SHORT SELLING

Since short selling, while in process, tends to depress price, owners of the thing suffering price depression view the operation with abhorrence. All potential buyers, to be sure, benefit by a lower price. But it in some way lies in human psychology that the prospect of having to come into ownership at a higher cost is not so painful as the prospect of having to part with something one owns at a lower price. Then, too, there is probably something of a feeling of abnormality, like the mediaeval feeling about interest. Money being a metal and inorganic cannot breed. The natural process of increase is the organic biological one. It is unnatural for money to increase. So to the modern mind the familiar way of profits is to buy low and sell high. The ordinary concept is of profit resulting from an increase in price. Making a profit out of a decline in price is abnormal. It is a ghoulish fattening on misfortune. But the misfortune of the seller at the lower level is the fortune of the buyer.

The classical argument for the social utility of the speculator is that his operations tend to stabilize price. Take our illustration for the moment from the field of commodities. On a prospect of a scanty wheat crop the speculator buys in anticipation of a rise in price. It is his opinion that in view of conditions the present prices are not high enough. Over the period of the ensuing year the forces of demand and supply will give a bushel of wheat a greater utility. The speculator's purchases increase the present price. The price increase, warning of the prospective shortage, presumably somewhat reduces present consumption and conserves the supply. And conversely, if the speculator foresees a larger crop than usual, he sells.

Securities, to be sure, are not consumed in the way wheat is consumed. But it is the theory that the speculator endeavors to foresee the working out of economic forces which will result in a general opinion of greater value than that expressed in present price. In common parlance stocks are worth more than they are selling for; the speculator recognizes that greater worth, and by his transactions helps it to expression in price. And conversely

if stocks are selling for more than they are worth. The speculator's liquidating sales tend to keep the price down as it rises; his covering purchases tend to keep it up as it falls.

However, as already indicated, speculators in practice by no manner of means base their operations exclusively on opinions of value. If the speculator thinks owners are going to liquidate in spite of values, he will sell, and his sales will accelerate and extend the price decline. Still there is no reason to look askance at his operations for the fall any more than at his operations for the rise.

POOLS

It requires substantial resources to manipulate the market, and the risks are at least considerable. When a trading pool speculates, it buys and sells. So does an individual speculator. For an ordinary trading account, however, there would be no need of a pool to speculate if the speculator did not count on his own transactions to influence the course of prices. Profits can be made on price changes arising out of existing forces substantially as well on a ten share transaction as on a ten hundred share one. Transactions must be of substantial magnitude, however, to force prices up or down, and such transactions require capital in large amount. So it follows simply that speculators associate in groups, in the usual form of joint venture, to carry on manipulative speculation. Such groups are called "pools." Those participating entrust their funds to a manager to trade at his discretion.

Operations of such pools tend to follow a fairly well defined course, and go through the processes of (1) accumulation, (2) shake out, (3) mark up, and (4) distribution. Of course if the pool is trading for the fall the "mark up" becomes a "mark down." During the period of accumulation the pool endeavors to attain its long or short position with as little disturbance as possible. If it is buying, it does not want its purchases to put the market up. The manager does not buy, buy, buy, in a course of rapid bidding for stock, but quietly takes what stock is offered in the market. In this stage the operations of the pool tend to hold the market in which it is operating at the existing level rather than to change the level. In spite of the desire of the manager to accumulate as cheaply as he can, and the caution of his transactions, they do add to the activity, and the increased trading attracts other speculators to the issue. They buy and the price rises.

Then the pool undertakes the "shake out." By rapid selling it lowers the price and frightens the outsiders to liquidate. The pool further accumulates on these liquidation sales. When its holdings have become sufficiently extensive it enters the third phase of its operations, the mark up. During the first process of accumulation the endeavor was to buy without lifting price. Now instead of waiting for stock to be offered it bids and lifts price rapidly enough to induce further purchases by outsiders. The pool now wants to bring "the public" in on the issue so that their purchase will tend to carry the bull movement along, and furnish a sufficiently broad base for the concluding distribution operations of the pool. On the purchases by outsiders the pool hopes to liquidate its long position without depressing the price below that of the average cost of its holdings, and so capture the profit it has sought. Of course, if the pool is operating for the fall and selling short, its transactions in each phase just reverse those of operations for the rise. Stated descriptively in this way the whole matter seems very simple, and as if manipulative operations were a road leading certainly to wealth. There are many "ifs" in the course of achieving the ends of their endeavor.

Such a pool is an ordinary trading pool. Sometimes a pool markets stock on which it has an option. At this point the primary and secondary markets merge into each other. We have seen the market supporting operations of a security syndicate engaged in distributing an issue. While the participants are selling for the syndicate the manager must peg the market so that no outside quotation at less than the syndicate price may remain outstanding. Operations, however, may go beyond price maintenance to trading intended to effect some actual distribution through the medium of the exchange. This situation extends to entire distribution through the exchange in the case of pools based on stock options.

Such options may be given directly or indirectly by the issuing corporation which desires additional financing, or they may be given by some large holder, institutional or individual, desiring to liquidate. The liquidation of a great block of securities without disorganizing the market requires skill. After the market break of 1929 a bank might find itself holding a large amount of an issue held as collateral for defaulted loans, and wish to liquidate. A group of stock market operators might form a pool to

a fair value; when it is unduly high, he cannot buy at a fair value. A corresponding situation may obtain if an issue is held in large blocks by comparatively few people. In such a case the market lies too much under the control of the few holders. Potential buyers and sellers are not numerous enough to stabilize price, to make advances and declines orderly. Such issues are especially subject to manipulative endeavor.

Eleventh Section

Federal Taxation and Regulation

CHAPTER LVI

Federal Taxation of Corporations

In some respects it is unfortunate that a book written for the purpose of affording an introduction to the subject of corporation finance should be written at this time; in other respects it is important that one should be written now. It is unfortunate because practice under the new Federal legislation affecting the subject has not become seasoned. Administrative and judicial interpretation even of the Securities Act and of the Securities Exchange Act has only begun, and at the time of writing this chapter has hardly begun for the new Federal scheme of taxation for corporations enacted by the Revenue Act of 1936. It cannot yet clearly be seen in what ways practice will change as a result of the new legislation. On the other hand, it is important that a book on corporation finance be written at this time. The new statutes undoubtedly effect great changes, some at the very foundations of the subject. Any view of it which does not have these changes in sight would be incomplete and, in various ways, distorted.

Nevertheless, it is most unsatisfactory to write at this moment about Federal taxation of corporations. We have a new Federal tax act each year. And none of the acts of recent years has so greatly changed the pattern of taxation as the Revenue Act of 1936. It is the object of sharp attack, however, and may not survive. Any session of Congress might make obsolete all of our learning. Yet it is the present endeavor at the solution of certain problems. The solution may eventually be rejected. Since the problems persist, our consideration of them will continue to have value, however obsolete our knowledge of the answers the present statute contains.

Income taxation makes us realize that corporate entity is so tough a ghost that it seems to have substance. Though the creditors, the government, and the stockholders have all the

rights there are to benefit from the income of a corporate enterprise, the nature of the rights of the stockholders is such that a proper levy of the tax becomes difficult. If it is levied at the source, on the corporation, the levy must be on a single income — the income belonging to the stockholders as a group.

We have four possibilities for levying the tax:

(1) It could be levied on the corporation alone, and dividends not included at all in the taxable income of the stockholder;

(2) It could be levied only on the stockholder;

(3) It could be levied on the corporation and dividends included in the taxable income of the stockholder without any modification of the rate by reason of the fact that the same income has been taxed to the corporation;

(4) It could be levied on the corporation and dividends included in the taxable income of the stockholder, with some modification of the rate by reason of the coincidental levy on the corporation.

There is only one income, only one addition to wealth. The form of business organization through which the income is produced does not increase ability to pay. Nevertheless, if we attempt to levy the tax at only one of the possible points of levy, we encounter difficulties.

Quite aside from the idea of progressive taxation, i.e., taxing individuals with larger incomes at higher rates, we could not work out fairness by taxing the corporate income only to the corporation and exempting it as income of the stockholder when received by him as dividends. When the stockholders come into the enjoyment of the corporate earnings, when the dividends enter into the income of the individual, the deductions of one stockholder differ from those of another. If we apply the principle of ability to pay, we perceive that the ability of the stockholder arises out of his total net, not just part of his net, and his deductions ought to be chargeable against his total gross.

It is the principle of a progressive rate of taxation, however, that creates the greatest difficulty. If a levy of the tax on the corporation and a complete exemption of dividends to the stockholder should be adopted, the principle of progressive taxation would not be carried out. So legislators are driven to abandon the idea of a levy on the corporation alone.

Why should the levy not be on the stockholder alone? The difficulty lies in the nature of the stockholder's rights in the in-

come. Though, after creditors and government, he is the sole beneficiary, his rights do not include a right of current distribution. Payment of dividends lies in the discretion of the directors. Disregarding administrative difficulties, and assuming that it would be reasonable to require the corporation to report the share of the current earnings allocatable to each stockholder, we should still have an insurmountable difficulty. If the earnings are not actually declared out as dividends, they have not come into the control of the stockholder. He has not yet arrived at the point at which he has any choice of his form of enjoyment. Failure of the directors to declare them out as dividends has forced him to increase his investment in the enterprise. Even more important, practically, the stockholder may have an income tax to pay and no funds he can use to pay it.

Disregard the fact that the earnings are income of the current year, and say that they are not income of the stockholder until he receives them in the form of dividends. That is a distortion of the idea of taxing income in the sense of the current production of wealth, and leaves the determination of the annual income resulting from corporate enterprise to the discretion of boards of directors. Some stockholders, in the hope that the rate of taxation will be reduced, have an interest in not having dividends declared until the reduction in the tax rate takes place. So we have difficulty in making the levy on the stockholders only.

In the various tax acts before that of 1936 the levy was both on the corporation and on the stockholder. That is, the statutes levied a tax on the corporations based on their income for the current year, and again levied on the stockholder when that income was declared out in dividends. In a sense this recognizes the limited right of the stockholder, and taxes him in part when he has received a benefit from the income to the extent of having his corporate values increase, and again taxes him when he receives the further benefit of complete control of the income. Disregarding the fact that the added tax is not a taxation of income at the time of the current accrual of wealth, this double levy could be regarded as approximating justice provided the sum of the two levies were not greater than the levy upon noncorporate activity. Stockholders who hope that the rate will be reduced, and who do not require the dividends for their own current needs, still have an interest in the corporate retention of earnings.

When part of the total levy is on the stockholder, the government does not currently derive the full tax benefit of the currently produced wealth. Presumably as in part an offset, it has made the sum of the two levies greater than the single levy on income from unincorporated enterprise. Such a policy disregards the probably greater future income resulting from the increase in capital employed, and the consequent probably greater future distributions. From the viewpoint of justice the greater total tax creates a penalty on the corporate form of enterprise.

SCHEME OF FEDERAL TAXATION OF CORPORATIONS IN THE REVENUE ACT OF 1936

The Federal Revenue Act of 1936 presents a bold endeavor at cutting the Gordian knot of "corporate entity" in order to solve the problem of taxing income produced by corporate enterprise. Without delaying to discuss the problem further at this point, we will consider an outline of the scheme for its solution. The outline will furnish a basis for further consideration of the difficulties of the plan, and will afford a basis for discussing probable consequences. The scheme comprises the following levies on the corporation:

(1) Normal tax
(2) Surtax on undistributed profits
(3) Surtax on improperly accumulated surplus
(4) Capital stock tax
(5) Excess profits tax

Operation of the scheme is modified for certain types of corporations; viz., for:

(1) Mutual investment companies
(2) Personal holding companies

This presents enough of the plan for the purposes of our consideration. We will first discuss it without taking into account the variations for the special types.

These sentences to taxation run concurrently, with a result opposite to that of so sentencing a criminal to several concurrent terms of imprisonment. The tax burden is cumulative. With the Federal taxation added to the State levies, the load raises a question whether society will be able to function in a system of private property.

NORMAL TAX

The act levies on the corporation a "normal tax" based on the entire "normal tax net income." Even this normal tax has become progressive.

Brackets of Normal Tax *Net Income*	Rate on Bracket *Amount*
To $2,000	8%
$2,000 to $15,000	11%
$15,000 to $40,000	13%
Over $40,000	15%

Our tax base for the normal tax is "normal tax income," which the act defines as net income, less interest on obligations of the United States, and also less eighty-five per cent of the amount received as dividends from a domestic corporation which is subject to income tax.[1]

In allowing a deduction of only eighty-five per cent of income received from corporations already taxed the act imposes a penalty on the holding company, and indeed on the ownership by a corporation of any stock of another corporation, however small in amount.

A progressive rate of taxation on the income of a group seems illogical. Why should a corporation earning $4000, with two stockholders, each owning one-half the shares, pay eleven per cent, when a corporation earning $2000, but with all its shares owned by one stockholder, pays only eight per cent? The corporate entity concept works the mischief. Furthermore, the $2000 income may represent a profit of twenty per cent and the $4000 a profit of only four per cent for the capital of the company.

SURTAX ON UNDISTRIBUTED PROFITS

With a surtax on undistributed profits the act attacks the problem of the nature of corporation group income. From the tax viewpoint the ideal would be to have all the annual increase in wealth arising out of the corporate enterprise distributed to

[1] The reader is cautioned here, and throughout the chapter, that for complete definitions, and, indeed, completeness in any respect, he must refer to the act itself. Only enough is given here to present the idea of the general scheme, and it does not at all cover all the cases the act takes into account.

the stockholders, in whose hands it could be taxed at the appropriate progressive rate for each individual. In effect the 1936 act says, "All right, let's force it out." So it imposes on undistributed profits a tax with a base of "adjusted net income." It arrives at adjusted net income by deducting from net income (1) the normal tax, (2) interest on Federal Government obligations. We note that in computing adjusted net income the corporation can take no credit for dividends paid to it out of income already taxed. The act in effect says to corporate enterprisers: "You can avoid this double burden by distributing. If you don't distribute, you will pay."

Again we have a progressive tax. Progression here is not on dollar amounts, however, but on the percentages of adjusted net income not distributed. Though the act does not recognize that a corporation may properly retain any surplus, still the retention of a small percentage is not as offensive as the retention of all, or of a large percentage. The rates are:

Brackets of Percentages of Adjusted Net Incomes	Rate on Each Bracket
To 10%	7%
10% to 20%	12%
20% to 40%	17%
40% to 60%	22%
60% to 100%	27%

So a corporation which retains as surplus all of the earnings of a year amounting to $100,000 will pay an undistributed profits surtax of $27,000. On retaining in another year $100,000 when earnings are $1,000,000 it will pay such a tax in the sum of $7000. Prosperous years are, to be sure, the normal times to build up surpluses.

SURTAX ON IMPROPERLY ACCUMULATED SURPLUS

If the failure to distribute earnings arises out of a purpose to prevent the imposition of the surtax on the individual incomes of its stockholders, the act imposes an additional surtax on the corporation. Federal income tax legislation has long contained penalties for the accumulation of surpluses not needed in the business. But the administrative authorities have not been much

disposed to challenge the discretion of the directors in building up surpluses. If they had attacked it, and had been no more successful than stockholders have been in making such an attack, the penalties would not have provided much revenue. The act now provides that "The fact that any corporation is a mere holding or investment company, or that the earnings or profits are permitted to accumulate beyond the reasonable needs of the business, shall be prima facie evidence of a purpose to avoid surtax upon shareholders." This does not go very far towards a complete test of purpose. It remains to be seen how useful this surtax on corporations improperly accumulating surplus will be, either in actual levy or in terrorism. Let us simply view the rates:

Bracket of Retained Net Income	Rate for the Bracket
To $100,000	25%
Over $100,000	35%

Here, however, the tax is not quite completely cumulative. If the corporation also pays a surtax on undistributed profits, the additional tax imposed, because of the taint of intent to avoid surtax on stockholders, is somewhat reduced. Question arises as to whether there could be any case in which a corporation having an "improperly accumulated surplus" would not also be subject to the general undistributed profits surtax. Presumably such a case could arise. The base on which the surtax on improperly accumulated surplus is computed is "retained net income," and retained net income is "special adjusted net income" minus the sum of dividends paid and also minus the amount of earnings which contracts entered into before May 1, 1936, require the corporation to retain. And special adjusted net income is different from adjusted net income from which the base is derived for the computation of surtax on undistributed profits. It would require the scope of a tax treatise to enter into the distinctions between adjusted net income and special adjusted net income, and we are endeavoring here only to get a view of the scheme of taxation presented by the act. We will defer consideration of earnings which contracts require the corporation to retain until we have seen the entire present plan of Federal taxes on corporations. This whole scheme of corporate taxation is under attack and may be radically revised at any time.

CAPITAL STOCK AND EXCESS PROFITS TAXES

The capital stock and excess profits taxes are interrelated.

Under the 1936 act the rate of the capital stock tax is $1 for each $1000 of the "adjusted declared value" of the capital stock of the corporation.

The present rates on "excess profits" are: six per cent on net income in excess of ten per cent, but not in excess of fifteen per cent on capital stock; twelve per cent on net income in excess of fifteen per cent on capital stock.

A corporation on making its first return for the purpose of the capital stock tax must declare the value of its capital stock. It will not be allowed to change this original value. However, from year to year it will adjust this capital account to reflect additions and diminutions.

Since the excess profits tax is based on percentages of profit on capital, these two correlative taxes confront the corporation with a dilemma. The lower it makes its original statement of capital, the higher the percentage of earnings will be. By saving on the amount of its capital stock tax it may penalize itself on the excess profits tax. Since the excess profits tax begins to bear on earnings in excess of ten per cent, a corporation would naturally tend to state its capital as high as it could, provided it anticipated that earnings would not exceed ten per cent. As an example of the operation of the two taxes consider the following:

Declared capital stock		$1000.00
Earnings		150.00
Tax (6% on $50 excess over 10%)	$3.00	
Capital stock tax	1.00	
Total tax	$4.00	

Declared capital stock		$1500.00
Earnings		150.00
Tax	....	
Capital stock tax	$1.50	
Total tax	$1.50	

Declared capital stock		$1000.00
Earnings		200.00
Tax (6% on $50 excess over 10%)	$3.00	
(12% on $50 excess over 15%)	6.00	
Capital stock tax	1.00	
Total tax	$10.00	

Declared capital stock		$1500.00
Earnings		200.00
Tax (6% on $50 excess over 10%)	$3.00	
Capital stock tax	1.50	
Total tax	$4.50	

One recurrent type of injustice in our income tax processes arises out of variable incomes. The taxpayer pays, not on his average income, but on the income of the current year. If the taxation were all at a flat rate and the tax base included the entire net income, the variation of income would make no difference. Progressive rates, however, may result in the taxpayer with a variable income paying far more taxes than he would pay if he could average his income.

So here with the excess profits tax it is quite possible for a corporation, with average earnings far less than ten per cent, nevertheless to pay the excess profits tax in its prosperous years.

CONTRACTS RESTRICTING THE PAYMENT OF DIVIDENDS

Now that we have seen the complicated general scheme of Federal corporate taxation, we can consider a few of the special aspects. One difficulty of an endeavor to force corporations to distribute current earnings arises from restrictive contracts. Corporations have frequently agreed with the buyers of their creditor securities that they would make payments to stockholders only after certain appropriations to surplus; or they have otherwise restricted the freedom of their dividend policies. Further, the act of 1936 levies the undistributed profits tax on a base of income. Of course dividend payments are distributions, and are credited against income in arriving at the tax base. But a corporation may have covenanted to pay off certain annual amounts on creditor securities, or to set up a sinking fund, or may otherwise have restricted itself as to the disposition of its earnings. So, in various ways, a corporation may not be free to apply all its current earnings to dividend payments. Is it to be penalized, then, for not doing what it cannot do without breach of contract? That act says that it is not, if the contract was entered into prior to May 1, 1936.

It follows that corporations may make such contracts after that date only at the cost of being penalized for "undistributed

profits." The act puts the strongest kind of pressure to be improvident in the creation of any creditor securities. Amortization provisions by way of sinking funds and serial repayments will result in "undistributed profits," and such profits will be taxed. But one of the criticisms of American financial practice is its tendency to rely on refunding instead of strengthening the corporate financial structure by amortization.

Also, by penalizing the various covenants in the interest of creditors, restricting the payment of dividends, the act has substantially interfered with the freedom to contract, in ways that are objectionable from any viewpoint except the viewpoint of the act, that all current earnings must be forced into the possession of stockholders so that the surtaxes on individual incomes may be applied to them.

CAPITAL STOCK DEFICITS AND THE UNDISTRIBUTED PROFITS TAX

It is a sound principle of corporation finance that a corporation should not have the right to pay dividends while its capital stock is impaired, no matter what the current earnings may be, and various jurisdictions adhere to this principle. In such jurisdictions it would be unlawful for a corporation to pay current earnings out of dividends as long as a capital stock deficit existed. Yet, under the act, apparently such undistributed current earnings would be subject to the surtax on undistributed profits. One assumes that they do not come under the protection of contracts preventing the payment of dividends. In a sense, to be sure, the entire corporate charter consisting of the corporation statutes and certificate of incorporation is a contract. But, to procure immunity from the surtax on undistributed profits, is it, as required by the act, "a written contract executed by the corporation"? To be sure, it is all written — statute, certificate, and all. But, to say nothing of the statute, not even the certificate of incorporation is executed by the corporation. It is executed by the incorporators for the purpose of bringing a corporation into existence. Besides, the same problem confronts corporations organized after May 1, 1936, and even a theory which made the corporation charter a contract would not apply to such subsequent incorporations. Operation of the tax seems to have had little consideration in drafting the statute.

SURTAX ON PERSONAL HOLDING COMPANIES

Somewhat outside of, but supplemental to, the general scheme of corporate taxation are two provisions, one for a surtax on "personal holding companies," the other a special treatment of "mutual investment companies."

One of the devices which have been commonly employed for "minimizing" individual income taxes has been the personal holding company. People whose incomes would run into the high surtax brackets could organize a corporation and transfer their securities to it. The income received by the corporation would be subject to the full corporation tax, and the individual taxpayer owning the shares would have the benefit only of the exemption of the dividends received from the corporation from the much lower individual normal income tax. Still, if the taxpayer's income were of such magnitude that on receiving it all each year he would run into very high surtaxes, he might prefer to suffer the penalty tax of the corporate form (and take his chance of an interpretation of surplus not needed in the business) in the hope that in the course of time the individual tax rates would be reduced and he could then begin to have his personal holding corporation make dividend distributions.

The act of 1936 attacks this situation by imposing on personal holding companies a special surtax on undistributed adjusted net income in addition to the regular normal tax, surtax on undistributed profits, and surtax on improperly accumulated surplus. The rates range through eight per cent on amounts up to $2000, eighteen per cent on amounts from $2000 to $100,000, and so on up to forty-eight per cent on amounts in excess of $1,000,000. In short, the act has made it more profitable for an individual not to impound income in a personal holding company, but to collect directly and pay the current surtaxes. It still remained for the taxpayer who may be willing to chance subjecting his assets to the jurisdiction of a foreign government to investigate the tax possibilities of incorporating in the Principality of Liechtenstein or elsewhere. Now, however, the Federal Revenue Act of 1937 (the so-called Loophole Act) has (Section II) enacted provisions to reach net income of foreign personal holding companies (all as defined in the act) by requiring its inclusion as gross income of the shareholder who is a citizen or resident of the United States. This rather extreme example of the doctrine of construc-

tive receipt is perhaps based on part of the definition of such a company, i.e., fifty per cent of the stock outstanding owned by not more than five individuals, citizens or residents of the United States. So those in control of the corporation presumably could have compelled distribution, and are to be treated as if they had.

MUTUAL INVESTMENT COMPANIES

One type of organization consists essentially of the pooling, by various participants, of investment funds under a single management, with the further arrangement that the participant may on proper notice withdraw his pro rata share of the pooled fund. The purpose is to obtain the investment advantage of a large fund which, by reason of its size, gains the benefit of more skilful supervision than a participant could give to his relatively small individual fund. The form of organization may be corporate or that of a trust. Either form comes under the act, which says that "The term 'mutual investment company' means any corporation (whether chartered or created as an investment trust or otherwise), other than a personal holding company ***," and goes on further to define the conditions which must exist in order for the organization to be deemed such a company. One of the conditions is that the participant may withdraw his pro rata share. If a number of individual investors appointed the same person their agent to manage their funds and gave him authority to mingle the several funds in an aggregate fund for investing and management, one assumes, though perhaps with some question, that the situation would not constitute a mutual investment company.

A mutual investment company in computing its net income for normal tax is not allowed the credit of eighty-five per cent of dividends it receives from a domestic corporation subject to tax. Also it is not allowed the benefit the act provides for other corporations of carrying over from a given year as credit available for the next two years dividend payments in the given year in excess of the adjusted net income for that year.

CONSIDERATION OF POLICY OF COMPELLING DISTRIBUTION OF CORPORATE EARNINGS

The purpose of the act in forcing the current distribution of current corporate income is clear enough. We have the annual

production of wealth. The State requires that part of it be surrendered from individual ownership for public use. By adopting the principle of progressive rates of income tax, it desires that those whose wealth increases should surrender their progressive amounts. Operation of the "corporate entity" interferes with these ratios of current contribution. So the State will force the corporation to distribute its current earnings in order that the progressive principle may operate contemporaneously with the wealth production.

Even from an exclusively tax viewpoint the argument is not entirely on the side of compelling current distribution. One of the great fiscal difficulties with an income tax is the variableness of the base. To meet this the State can reduce public expenditure or it can increase the rate, or it can borrow. A reduction in public expenditure meets vigorous opposition. An increase in the rate takes a greater proportion of wealth from individuals when, with their reduced incomes, they find it most burdensome. Borrowing is the ever available public recourse, with its consequent discouragement of hope.

At least the better managed corporations tend to build up their surpluses most during their periods of relatively high incomes. To the extent that they carry them in liquid form they are able to distribute during periods of low income. In some measure they tend to level out individual incomes, and in this way decrease the variation in the tax base.

Since an earlier chapter has expressed a belief that as far as practicable stockholders ought to be given an opportunity to exercise their individual judgments as to whether or not they should increase their commitments in a given enterprise, it should be clear that the writer is sympathetic with the viewpoint of current distributions. Though appreciating the tax problems involved, he is very dubious, to say the least, about the desirability of governmental compulsion. From the viewpoint of the policy of private enterprise the stockholders in the long run have the matter in their own hands. If they feel that a greater proportion of current income should be currently distributed, they can vote for a board of directors more favorable to disbursement. The remedy here lies in the development of active stockholder interest. It can take into account the problems peculiar to each enterprise. A tax policy of compulsory distribution must lay down a rule regardless of special circumstances of individual corporations.

Enterprise may have two kinds of capital — creditor and contributed. The extent to which the exigencies of promotion and the speculative desire to trade on the equity have carried the use of creditor capital in American enterprise has long been a cause of criticism. Presumably, if we are to prevent corporations from increasing capital account out of earnings, we do not want to force them to resort to borrowing. Even if we did, one corporation is not in the same position as another to borrow. Aside from borrowing, a corporation can appeal to its own stockholders to make a voluntary addition to their commitment in the enterprise, and on their failure to contribute the desired amount it can invite subscriptions from outsiders. The chances of success in any case depend on the conditions of the particular enterprise. If the stock is of par value and is not worth par, the corporation cannot finance by this means. Yet apparently it is to be forced to resort to borrowing, or penalized for its only other recourse of applying earnings to capital account.

Then, too, there is a vast difference between the large corporation with stock listed and actively dealt in on the exchange and the relatively small corporation with little or no market for its shares. The large corporation with active listed shares imposes little hardship on its stockholders in creating subscription rights. Those who are not in a position to subscribe probably do not lose much in value by selling their rights. If the stock of such a corporation sells substantially above par, the enterprise will not have difficulty in procuring the desired funds.

A small corporation, with no secondary market for its shares, on creating subscription rights, imposes a hardship on some of its stockholders. They may not be in a position to take up the additional stock. There is no market in which they can sell their rights. So they may suffer a substantial loss of value. Moreover, such a corporation finds it far more expensive to find new stockholders. A spread of ten points might well be moderate on the sale of its shares, as compared with a spread of five points, or perhaps much less, for the large corporation.

Directors have the responsibility for corporate enterprise. In a particular instance a retention of the entire current earnings, if tax problems could be disregarded, may be clearly the way of wisdom. But the average of the several brackets of the undistributed profits tax is over twenty per cent. The directors must choose between the dangerous course of paying a dividend and

the very unhappy course of penalizing their stockholders to the extent of more than a fifth of the corporate earnings.

Writing this chapter has been a most unsatisfactory task. It is entirely possible that not even the outline of the Federal scheme of taxation in the act of 1936 will endure for a brief period of years. Yet it profoundly affects corporation finance, and could not be passed over without consideration. By February, 1938, the political breeze seems to blow in the direction of a repeal or great modification of the undistributed profits tax. Even if the tax is repealed, the discussion is perhaps not without value. It shows the need of more than casual consideration of the problems involved before making legislative changes affecting corporate affairs.

CHAPTER LVII

Government Regulation of Corporate Enterprise

Inclusion in this book of a chapter on government regulation of corporate enterprise perhaps needs some apology. The essential tenor of the work relates to corporate financing, and government regulation of the conduct of business may have no more relation to financial operations than problems of labor relations, or efficient plant layout, have. Yet omission of this chapter would equally require apology. For some of the regulation, intermingled with the mass, includes supervision over securities issuance, which is directly corporation finance, and some is related to the conditions under which corporate consolidation or combination may take place, and in that way affects the problem of corporate structure.

Rate regulation affects earning power which supports securities issues (or fails to support them) and indirectly affects the financing. Though rates are more directly an investment than a finance problem, the two things are interrelated; and, further, the same statutes which provide for the regulation of security issues also provide for the regulation of rates. So this section will mention rate regulation as well as other government regulation of enterprise. Though the regulation is primarily a regulation of business rather than of corporations as such, it is a matter of fact that substantially all enterprise affected is carried on by corporations, and further apology hardly need be made on this account. Certain requirements affecting those who may serve as directors are distinctly corporate.

Necessarily, this chapter can include only a summary of government regulation — no more than an outline, and, even further, only an outline of Federal regulation. State regulation is pervasive in the field of public utility enterprise. Even in the field of Federal regulation, and even limited to a summary, the outline

will hardly be comprehensive. But this book is in no degree intended to be a guide to practice. This work endeavors only to present a bird's-eye survey of corporations and their financing to assist those who are endeavoring to gain some comprehension of the nature of the problems involved.

For the purposes of this section we will divide government regulation into the three fields of railroad enterprises, public utility enterprises, and industrial enterprises.

OUTLINE OF FEDERAL STATUTES REGULATING RAILROADS

The succession of the principal Federal statutes for the regulation of railroads is:

Interstate Commerce Act — The Act to Regulate Commerce, February 4, 1887. This act initiated Federal regulation of railroads by supervision of the Interstate Commerce Commission.

Sherman Anti-Trust Act — An Act to Protect Trade and Commerce against Unlawful Restraints and Monopolies, July 2, 1890. Though this act was not confined in its operation to railroads, but indeed was directed more especially at industrial enterprises, its scope took in railroads.

Elkins Amendment to Interstate Commerce Act, February 19, 1903. This made any deviation from the published tariff of rates a misdemeanor.

Hepburn Act, June 29, 1906. This extended the operation of the Interstate Commerce Act to express and sleeping car companies and pipe lines, transportation part water and part rail (but not all by water), switches, spurs, and terminal facilities. It broadened the definition of transportation and conferred on the Commission mandatory power over furnishing accounts.

Mann-Elkins Act, June 18, 1910. This act (1) granted to the Commission power to suspend changes in rates for inquiry into reasonableness; (2) dealt with the "long and short haul" clause; (3) created the Commerce Court.

Act for the Valuation of the Property of Carriers, March 1, 1913. This authorized the Commission to carry on an investigation to ascertain the cost of the property of carriers.

Esch-Cummins Act, February 28, 1920. This act (1) dealt with rates to provide for fair return to railroad properties as a whole, and a pooling of profits; (2) gave the Commission exclusive

jurisdiction over the securities issuance of interstate carriers; (3) authorized a board of labor adjustments; (4) provided for consolidations approved by the Commission.

OUTLINE OF FEDERAL STATUTES REGULATING INDUSTRIAL ENTERPRISE

The number of Federal statutes enacted to regulate industrial enterprise is not so great as the number to regulate railroads, and the industrial regulatory statutes have assumed that fair competition will result in a fair price. The leading statutes are:

Sherman Anti-Trust Act, July 2, 1890. As was said in naming this statute under the head of railroads, it was directed primarily against industrial combinations in restraint of trade, but brought such railroad combination within its scope as well.

Bureau of Corporations Act, February 14, 1903. This act created the United States Bureau of Corporations, which subsequently the Federal Trade Commission replaced.

Federal Trade Commission Act, September 26, 1914. This declared unfair methods of competition unlawful and set up the Federal Trade Commission to enforce the act and also the Clayton Act.

Clayton Act, October 15, 1914. This act made it unlawful to discriminate in price if "the effect of such discrimination may be to substantially lessen competition or tend to create a monopoly in any line of commerce." It specifically forbade exclusive sales contracts, and the acquisition of the stock of a corporation if "the effect of such acquisition may be to substantially lessen competition between the corporation whose stock is so acquired and the corporation making the acquisition," or to restrain commerce in any section or community, or tend to create a monopoly of any line of commerce. The act also prohibited interlocking bank directorates.

Patman-Robinson Act, June 19, 1936. The act apparently aims at preventing price discrimination on any other basis than quantity sales. That is, apparently a classification of customers should not be made for the purpose of granting different prices on the same quantity to different classes of customers.

FEDERAL REGULATION OF PUBLIC UTILITIES

Regulation of telephone and telegraph enterprises was given to the Interstate Commerce Commission. The nature of the

service of the electric power and light and of the gas business was such as not to bring them much into the field of interstate commerce, and until recently the Federal Government made no attempt to supervise them. Development of the radio created a situation necessarily calling for Federal supervision.

Radio Act of 1927, February 23, 1927. This provides for the regulation of radio communication and establishes a supervising commission.

Public Utilities Act of 1935 (*Public Utility Holding Company Act*), August 26, 1935. This act deals with the development of holding companies in the electric power and light and in the gas business, and has already been summarized in Chapter XXII.

The following pages of this chapter will simply expand a little the preceding outline.

NO FEDERAL COMMON LAW

Our Constitution conferred certain specified powers on the Federal Government. All Federal law has its origin in or through the express grants of that instrument. Though the several States inherited the Common Law of England as it stood at the time of their separation from that country, the Federal Government has no Common Law. So the Common Law prohibitions of monopoly do not apply to matters of Federal jurisdiction. And interstate commerce constitutes one of these matters. State law cannot interfere with commerce between the States.

Here we have one of the difficulties of the duality of our form of government. State authority cannot interfere with interstate matters: Federal authority cannot interfere with intrastate matters. If all anti-social matters are to be caught, a net must be woven of both State and Federal laws. As our economic organization becomes an increasingly intricate combination of intrastate and interstate activity, the weaving of a sufficiently fine net becomes increasingly difficult. In the endeavor the Constitution gets stretched to the extent of its elasticity, and one marvels sometimes at the distance which the Supreme Court is able to stretch it.

ACT TO REGULATE COMMERCE

In 1887 Congress enacted the Act to Regulate Commerce which dealt with interstate transportation. This is the earliest of the

great Federal regulatory statutes. Setting up the Interstate Commerce Commission to carry out its provisions, it prohibited personal discrimination among shippers by way of rebates or otherwise. It also forbade discrimination among localities. To these ends it required the posting and filing of rate and fare schedules. It forbade pooling and traffic agreements. And it contained the famous "long and short haul clause":

> That it shall be unlawful for any common carrier subject to the provisions of this act, to charge or receive any greater compensation in the aggregate for the transportation of passengers or of like kind of property, under substantially similar circumstances and conditions, for a shorter than for a longer distance over the same line, in the same direction, the shorter being included within the longer distance; but this shall not be construed as authorizing any common carrier within the terms of this act to charge and receive as great compensation for a shorter as for a longer distance: Provided, however, that upon application to the Commission appointed under the provisions of this act, such common carrier may in special cases, after investigation by the Commission, be authorized to charge less for longer than for shorter distances for the transportation of passengers or property; and the Commission may from time to time prescribe the extent to which such designated common carrier may be relieved from the operation of the act.

SHERMAN ANTI-TRUST ACT

Enacted July 2, 1890, the Sherman Anti-Trust Act, carrying the statutory title of "An act to protect trade and commerce against unlawful restraints and monopolies," provides that:

> Every contract, combination in the form of a trust or otherwise, or conspiracy in restraint of trade or commerce among the several States, or with foreign nations, is hereby declared to be illegal. Every person who shall make any such contract or engage in any such combination or conspiracy, shall be deemed guilty of a misdemeanor ***.

For some time doubt was felt as to whether or not the acts of carriers, merely transporting goods in commerce, and not directly making prices, could be in restraint of trade. Two cases, that of the Trans Missouri Freight Association[1] and that of the Joint Traffic Association,[2] completely resolved this doubt, and clearly brought railroads under the act.

Under the Interstate Commerce Act as it then stood it was

[1] 166 U. S. 312 (1897).
[2] 171 U. S. 564 (1898).

necessary to prove discrimination. The Elkins Amendment in 1903 made any variance from the published rates unlawful and a misdemeanor. All that has to be proved under the revised law is that the rate charged is not the one promulgated.

The association cases referred to above decided that rate fixing agreements of two or more corporations were restraints of trade. But if control of competing corporations should be obtained by a holding company, so that in result rates could be made non-competitive without contractual means, would constituting such a corporation be an act in restraint of trade? It was held to be such in the case of the Northern Securities Company.[1] This New Jersey corporation, by exchanging stock, acquired control of the Northern Pacific and the Great Northern Railroads. The holding company itself was, of course, entirely intrastate. Nevertheless, the court held that the authority of a State to charter a corporation does not extend to protect that corporation in the use of its franchise to effect a restraint of interstate commerce, which is under the jurisdiction of Congress.

Some but not all of the railroads entering St. Louis acquired control of terminal facilities. Since not all the entering railroads were to enjoy the use of the terminal facilities on equal terms, the control was held, in the case of the Terminal Railroad Association of St. Louis,[2] an illegal restraint of trade.

Only a suggestion or two has been given of the long course of defining the scope of the Sherman Anti-Trust Act in relation to the railroads. And no further reference is being made to the Hepburn Act and the Mann-Elkins Act mentioned in the introductory outline.

ACT FOR THE VALUATION OF THE PROPERTY OF CARRIERS

Under the act the Interstate Commerce Commission is to prescribe rates under which the carriers as a whole may earn an aggregate net railway operating income equal as nearly as may be to a fair return on the total value of the railway properties used in transportation. The Commission is charged with the duty of reporting in detail, for each piece of railroad property, on (1) the original cost to date, (2) the cost of reproduction less

[1] 193 U. S. 332 (1904).
[2] 224 U. S. 409 (1912).

depreciation, and (3) the methods used in obtaining the costs. In reporting on cost of reproduction the Commission takes the wage and price level of June 30, 1914. After ascertaining these costs and taking into account "other value and elements of value," the Commission reports a "final value." The findings of the Commission are subject to judicial review.

Advocates of the valuation regarded it with high hopes of its being an important part of the solution of just rates. Unfortunately, for the past seven years the real economic problem has seemed to be, not a reduction of rates to a point of justice, but for the roads to get enough traffic to keep going. The recent experiment of the Interstate Commerce Commission in ordering a reduction in passenger fares was not a matter of rate making to provide that the return on capital should not be more than fair, but an endeavor to attract business to the rails in competition with motor buses. However, even more recently the Commission has denied an application for the continuance of "emergency" surcharge rates.

PROBLEM OF VALUATION

Principles indicated in the case of *Smyth v. Ames*,[1] have been affecting judicial consideration of capital value for purpose of rate making, both State and Federal, ever since. The rate making problem as stated by the courts broadly, and with a correlative vagueness, is that of a "fair return on a fair value." But what is a "fair return," and what is a "fair value"? It was said in *Smyth v. Ames* that the following elements should be taken into consideration and given such weight as may be just and right:

Original cost
Capital additions
Market value of stock and bonds
Cost of reproduction
Probable earnings under particular rates
Operating expenses

Though these items are not listed in this form in the language of the case, the phrases used sufficiently indicate its tenor.

It is obvious that the first two, original cost and capital addi-

[1] 169 U. S. 466.

tions, come to the one thing, actual cost of the property. One school of rate making believes that this alone would be the fairest value for a rate base. It represents the capital that investors have actually contributed, on which it is fair that they should make a return.

Such a base of actual cost denies the investor the possible speculative benefits, first, of unearned increments — increases in value due to the growth of the community — and, second, of increases of the expression of value in currency terms due to any rise of the price level. Correlatively, it denies the community, first, the benefits of decreases in value due to the decline of the community or of the development of competitive agencies; second, of decreases in the expression of value in currency terms due to declines in the price level; and, third, of decreases in value due to the progress of invention making it possible to replace a plant with one of equal efficiency at less cost. In short, it largely takes out the speculative elements.

Whatever the value base to which the rate is to be applied, the rate is to be one which will provide a "fair return." Whatever the route by which the conclusion is reached, it is a rate of return sufficient to attract any new capital which may be needed to give the community the service it desires. Here we have a speculative element left in full force. The return on capital previously committed is to depend on the value of capital in the given risk conditions at the time when a revision of rates is under consideration.

Probably in the course of a century it would make little difference what rate base is taken, whether prudent investment cost or something arrived at as current value. In the long run the risk involved in the nature of the rate base would work itself out in the rate of return required by capital. However, a gross immediate injustice may be done in the determination of a rate base to be presently used. Few investors live a hundred years to derive a benefit from a righting of their present wrongs. The problem is akin to that of the progress of invention which renders special skills obsolete and throws men out of employment.

It will be noted that the possibility of the substitution of regulation for competition in determining rates depends on a competitive element, the competition of capital seeking commitment. If the element were taken away, and, for example, the State supplied the capital by taxation, in what way, with respect to

the worth of capital, could any inference of fairness of rates be drawn? To base the rate on the cost of capital acquired through the issuance of government or municipal bonds would be to give production the benefit of a credit based on a first claim on all the wealth of the community.

DID THE SHERMAN ACT PERMIT REASONABLE RESTRAINT OF TRADE?

One matter of interpretation of the Sherman Act had to be determined. The title to the act seemed to contain an ambiguity. It is "An act to protect trade and commerce against *unlawful* restraints of trade." An inference might be drawn that the act intended only to put in statutory form for Federal purposes what the Common Law made illegal in the several States. The legality of many contracts partially restraining trade is not adversely affected by anti-monopoly principles of the Common Law. For example, a man selling his business may sell the good will of the business and agree not to compete with the buyer for a period of time or within a limited area.

However, the act itself provides that "*every* contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several States, or with foreign nations, is hereby declared to be illegal." Reading back from this to the title, the act makes unlawful every contract which restrains, and the title refers simply to what the act actually provides.

At first, in the Trans Missouri Freight Association case,[1] the court gave the act a strict construction, and said that literally every contract in restraint of trade was unlawful, whether the restraint was reasonable or not. For the actual conduct of human affairs, however, this position was untenable. A little later Justice Peckham, in his majority opinion in the Joint Traffic Association case,[2] indicated that the act must be interpreted reasonably. Finally, more than a decade later, in an industrial case, that of the Standard Oil Company,[3] the court came out squarely for the rule of reason.

We will not comment at all on the other acts regulating rail-

[1] 166 U. S. 312 (1897).
[2] 171 U. S. 564 (1898).
[3] 221 U. S. 48.

roads indicated in the outline at the beginning of this chapter. Indeed, we have not even mentioned many aspects of the development of this regulation. Perhaps enough has been said to suggest its trend.

REGULATION OF INDUSTRIAL ENTERPRISE

The Sherman Anti-Trust Act, probably thought of in its inception as primarily a regulation of industrial enterprise, had its development in this field. The Standard Oil case, setting forth the rule of reason, has been mentioned. The E. C. Knight case[1] indicated that mere bigness, achieved by acquiring the assets of existing enterprises, would not in itself be an unlawful restraint of trade. But further legislation was to assume a great part of the regulation of industrial enterprise.

BUREAU OF CORPORATIONS ACT — FEDERAL TRADE COMMISSION ACT — CLAYTON ACT

Under the auspices of the United States Bureau of Corporations created by the act of 1903 the Theodore Rooseveltian era of "trust busting" went forward with its series of dissolution suits. They ran their course. However, it came to be seen that monopoly was not the only economic abuse, and new regulatory measures were gestating.

In the governorship of Woodrow Wilson the legislature of New Jersey enacted a series of seven bills for State regulation of business, known at the time as the Seven Sisters. Eight bills were introduced, one a Blue Sky measure. It was the period of general Blue Sky enactments. But the New Jersey bill was not enacted.[2] The other seven were, and furnished the program for Federal legislation on the election of Governor Wilson to the Presidency of the United States. This legislation took form in the Federal Trade Commission Act, September 26, 1914, and in the Clayton Act, October 15, 1914.

The Trade Commission provides generally that unfair methods of competition are unlawful. The Clayton Act specifies certain practices as unfair, and forbids:

[1] 156 U. S. 1 (1895).

[2] One of the memories of the author is of appearing and arguing at length before the joint legislative committee on the difficulties of the Blue Sky bill as drafted.

Price discrimination
Exclusive sales contracts
Acquiring the stock of another corporation, if the effect may be substantially to lessen competition
Interlocking directors of banks and of competitive enterprises
Common carriers dealing with (presumptively) parasitic corporations.

Since the act deals with matters of transportation and banking as well as with industrial and commercial enterprise, it gives supervision for enforcement in the respective fields to: (1) the Interstate Commerce Commission, (2) the Federal Reserve Board, and (3) the Federal Trade Commission.

With respect to price discrimination, however, the act contains a proviso, which is of special interest in connection with more recent legislation known as the Patman Act, and says:

> Provided, that nothing herein contained shall prevent discrimination in price between purchasers of commodities on account of differences in the grade, quality or quantity of the thing sold, or that makes only due allowance for differences in the cost of selling or transportation, or discrimination in price in the same or different commodities made in good faith to meet competition: And provided further, that nothing herein contained shall prevent persons engaged in selling goods, wares or merchandise in commerce from selecting their own customers in bona fide transactions and not in restraint of trade.

Speaking broadly, the Clayton Act forbids conduct which has a tendency to lessen competition. To make the conduct unlawful the tendency must be necessarily inherent or must be shown. The Trade Commission Act much more broadly prohibits unfair methods of competition. It does not limit its scope to conduct which has a monopolistic tendency. Under it the Trade Commission matters have fallen generally into three classes: (1) misrepresentations, (2) bribery, and (3) resale price maintenance.

The Commission may investigate either on its own initiative or on complaint. If, on investigation, it finds evidence that an unfair practice exists, it gives notice of a hearing at which the concern under investigation may appear and "show cause" why an order to "cease and desist" should not issue. The Commission states its conclusions in a report of facts, and if it finds an unfair practice it issues its order. If the alleged offender does

not obey the order, the Commission may appeal to the designated Federal court to enforce it. Likewise the concern against which an order has been made may obtain a review of the order on an appeal to the court. The act, however, makes the Commission's findings of fact conclusive. In actual practice investigated concerns often settle the matter by consenting to the entry of a court decree.

One result of the work of the Trade Commission was the development of the Trade Practice Conference. Representatives of an industry vote on a question as to whether or not a certain practice is fair competition. The Commission approves or disapproves the action of the conference. On approval the Commission communicates with concerns not represented at the conference, and endeavors to obtain an expression of their adherence. But the Commission investigates any violation of the conference rules by the non-assenting as well as violations by the assenting. In short, the rules establish a presumption as to the fairness of a practice. It is easy to perceive that the N. R. A. codes of fair practice at the beginning of the first administration of Franklin Roosevelt were an endeavor to extend the scope of the idea inherent in the Trade Practice Conferences.

PATMAN-ROBINSON ACT

An amendment to the Clayton Act, known as the Patman-Robinson or, more briefly, the Patman Act, enacted June 16, 1936, adds to the number of practices statutorily stated to be unfair. The constitutionality of some of its provisions is questioned, but this aspect of the statute will not be considered here. The act provides:

That it shall be unlawful for any person engaged in commerce, in the course of such commerce, either directly or indirectly, to discriminate in price between different purchases of commodities of like grade and quality, where either or any of the purchases involved in such discrimination are in commerce, where such commodities are sold for use, consumption, or resale within the United States or any territory thereof or the District of Columbia or any insular possession or other place under the jurisdiction of the United States, and where the effect of such discrimination may be substantially to lessen competition or tend to create a monopoly in any line of commerce, or to injure, destroy or prevent competition with any line of commerce, or to injure, destroy, or prevent competition with any person who either grants or knowingly receives the benefit of such

discrimination or with customers of either of them: *provided* That nothing herein contained shall prevent differentials which make only due allowance for differences in the cost of manufacture, sale, or delivery resulting from the differing methods or quantities in which such commodities are to such purchasers sold or delivered.

The act goes on with a further proviso that the Federal Trade Commission may, after investigation and hearing, fix quantity limits

*** where it finds that available purchasers in greater quantities are so few as to render differentials on account thereof unjustly discriminatory or promotive of monopoly in any line of commerce; and the foregoing shall not then be construed to permit differentials based on differences in quantities greater than those so fixed and established; *And provided further*, that nothing herein contained shall prevent persons engaged in selling goods, wares and merchandise in commerce from selecting their own customers in bona fide transactions and not in restraint of trade.

Hitting the buyer as well as the seller, the act further provides:

That it shall be unlawful for any person engaged in commerce, in the course of such commerce, knowingly to induce or receive a discrimination in price which is prohibited by this section.

It will be noted that the act makes no exception of discrimination in price made in good faith to meet competition, and that it limits the application of price differentials due to difference in quantity.

INDEX